No. 15815

United States
Court of Appeals
for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

GRACE H. CUNNINGHAM, EUGENE F. CUNNINGHAM and GRACE H. CUNNINGHAM,

Respondents.

Transcript of Record

Petitions to Review a Decision of the Tax Court of the United States

Phillips & Van Orden Co., 4th & Berry, San Francisco, Calif.—2-28-58

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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APPEARANCES

CHARLES K. RICE,
Assistant Attorney General,
Department of Justice,
Washington, D. C.,

For the Petitioner.

RAYMOND D. OGDEN,
RAYMOND D. OGDEN, JR.,
462 Olympic Nat'l Bldg.,
Seattle 4, Washington,

For the Respondents.

The Tax Court of the United States

Docket No. 55090

GRACE H. CUNNINGHAM,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DOCKET ENTRIES

1954

Oct. 22—Petition received and filed. Taxpayer notified. Fee paid.

Oct. 22—Copy of petition served on General Counsel.

Nov. 22—Answer filed by G. C.

Nov. 22—Request for hearing in Seattle, Wash., filed by G. C.

Nov. 29—Notice issued placing proceeding on Seattle, Wash., calendar. Service of answer and request made.

1956

Mar. 14—Hearing set May 14, 1956, Seattle.

May 17—Hearing had before Judge Atkins on the merits on joint oral motion to consolidate dockets 55090-91 for trial and opinion, granted. Stipulation of facts filed at hearing. Briefs 7/16/56. Replies 8/15/56.

June 6—Transcript of hearing 5/17/56 filed.

June 12—Correction of stipulation of facts filed.

1956

July 11—Brief filed by Petitioner. 7/17/56 served.

July 16—Brief filed by Respondent. 7/17/56 served.

Aug. 14—Reply Brief filed by Petitioner. 8/15/56 served.

Aug. 16—Reply Brief filed by Respondent. 8/17/56 served.

1957

June 17—Findings of fact and opinion filed, Atkins, J. Decision will be entered for Petr., served 6/17/57.

June 25—Decision entered, Judge Atkins, Div. 7, served 6/26/57.

Sept. 16—Petition for review by U. S. Ct. of Ap., 9th Cir., filed by Resp.

Oct. 2—Proof of service filed (counsel).

Oct. 1—Motion by resp. for extension of time for filing record on review and docketing pet. for review to Dec. 13, 1957.

Oct. 2—Order extending time for filing record on review and docketing petition for review to Dec. 15, 1957, entered, served 10/3/57.

Oct. 2—Proof of service on Petr.

Dec. 9—Designation of contents of record on review with proof of service thereon, filed.

The Tax Court of the United States

Docket No. 55091

EUGENE F. CUNNINGHAM and GRACE H. CUNNINGHAM, Husband and Wife,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DOCKET ENTRIES

1954

Oct. 22—Petition received and filed. Taxpayer notified. Fee paid.

Oct. 22—Copy of petition served on General Counsel.

Nov. 22—Answer filed by G. C.

Nov. 22—Request for hearing in Seattle, Wash., filed by G. C.

Nov. 26—Notice issued placing proceeding on Seattle, Wash., calendar. Service of answer and request made.

1956

Mar. 14—Hearing set May 14, 1956, Seattle.

May 17—Hearing had before Judge Atkins on the merits on joint oral motion to consolidate dockets 55090-91 for trial and opinion, granted. Stipulation of facts filed at hearing. Briefs 7/16/56. Replies 8/15/56.

June 6—Transcript of hearing, 5/17/56, filed.

1956

June 12—Correction of stipulation of facts filed.

July 11—Brief filed by Petitioner. 7/17/56 served.

July 16—Brief filed by Respondent. 7/17/56 served.

Aug. 14—Reply Brief filed by Petitioner. 8/15/56 served.

Aug. 16—Reply Brief filed by Respondent. 8/17/56 served.

1957

June 17—Findings of fact and opinion filed, Atkins, J. Decision will be entered for Petrs., served 6/17/57.

June 25—Decision entered, Judge Atkins, Div. 7, served 6/26/57.

Sept. 16—Petition for review by U. S. Ct. of Ap., 9th Cir., filed by Resp.

Oct. 2—Proof of service filed (counsel).

Oct. 1—Motion by Resp. for extension of time for filing record on review and docketing pet. for review to 12/13/57.

Oct. 2—Order extending time for filing record on review and docketing petition for review to 12/15/57, entered, served 10/3/57.

Oct. 2—Proof of service on Petr.

Dec. 9—Designation of contents of record on review with proof of service thereon, filed.

The Tax Court of the United States

Docket No. 55090

GRACE H. CUNNINGHAM,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Ap:S:AA:90D-JEQ:MHB-JEQ:MEB-fb) dated August 25, 1954, and as a basis for his proceeding alleges as follows:

1. The petitioner is a married woman whose residence address is 2026 Louisa Street, Seattle, Washington. The return for the period here involved was filed with the District Director of Internal Revenue at Tacoma, Washington, formerly known as the Collector of Internal Revenue.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on August 25, 1954.

3. The taxes in controversy are alleged income for the calendar year of 1946 and in the amount of $6,725.59.

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) The Commissioner erred in adding to net income of the taxpayer for the taxable year ending December 31, 1946, the sum of $14,714.60 as rental income which purported to represent the alleged fair market value of improvements erected by lessee on taxpayer's (lessor's) leased lands under the terms of a written lease.

(b) The Commissioner erred in holding that the improvements placed upon taxpayer's (lessor's) real property by lessee under terms of a written lease constituted rental to the lessor.

(c) The Commissioner erred in failing to find that the lease made no provision whatsoever for rental and that it was the agreement between the parties that there would be no rental other than payment of taxes.

(d) The Commissioner erred in failing to hold as a matter of law that the improvements erected by lessee became, by reason of being annexed to the freehold, the property of the taxpayer immediately upon completion of the improvements.

(e) The Commissioner erred in determining the fair market value of the improvements by using an arithmetical formula which gave no consideration to the many factors that go to make up fair market value.

(f) The Commissioner erred in failing to determine the amount of fair rental for the lands described in the lease for the period of the leasehold.

(g) The Commissioner erred in holding that the principal consideration for the lease was an agreement to transfer to taxpayer all of lessee's improvements at the expiration of the lease.

(h) The Commissioner erred in not holding that the true consideration for the lease was the agreement on behalf of the lessee to pay taxes.

(i) The Commissioner erred in holding that there was a liquidation of lease rental in kind where under the terms of the lease no lease rental, other than taxes, was required.

(j) Under the facts in this case the Commissioner erred in assessing any deficiency on any ground whatsoever.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a, b, c) There was a written lease executed covering Lots 8, 9, 10, 11 and 12, Block 2102, Tacoma Land Company, Fifth Addition, Pierce County, Washington, running between Grace H. Cunningham, as lessor, and the American Manufacturing Company, as lessee, in which lease there was no provision for rent other than the payment of taxes. The period of the lease was six years. The minutes of the American Manufacturing Company relating to said lease specifically recite that there was to be

no rent charged other than payment of taxes, which taxes average approximately $46 per month during the life of the lease. There was no statement in the lease nor in the minutes of the corporation, nor was it the intent of the parties that the building erected upon the leased premises by the lessee was in lieu of rent.

(d) The improvements erected by the lessee were unseverable and permanent improvements, the title to such improvements was at all times vested in the lessor immediately upon their attachment to the realty.

(e) The fair market value is not that found by the mathematical formula presented by respondent but instead the fair market value was not in excess of $8,000.00.

(f) The six-year lease to which reference has heretofore been made was strictly a ground lease. The fair rental value for said lands covered by said lease as of 1946 did not exceed $10 per month.

(g, h) The principal consideration for the lease was payment of taxes by the lessee. The building was built for the exclusive use of the lessee. Upon the termination of the six-year lease, January, 1952, a new lease was executed between the same parties, in which the lessee agreed to pay $10 per month rent as well as all taxes and payment of insurance, thus negativing the conclusion of the Commissioner that the consideration for the six-year lease was the

benefit the lessor would derive from ownership of the building.

(i) There was no provision in the lease that the building erected by the lessee was to be considered as liquidation in part or in whole of leased rental, nor were there any facts from which the Commissioner could rightfully conclude that it was the intention of the parties that the building erected by the lessee on the leased land was to be considered as in lieu of rent. The only rental requirement was payment of taxes and they were properly paid to cover all promises by lessee as rental consideration for the leased premises. The payment of taxes was adequate rent for use of the property rented and there is nothing further in the dealings between landlord and tenant in this case to indicate any intention to contract for any further payments, directly or indirectly, or in the form of property improvements.

(j) The error referred to in (j) speaks for itself.

6. Wherefore, the petitioner prays that this Board may hear the proceeding and redetermine the deficiency alleged by the respondent Commissioner.

/s/ RAYMOND D. OGDEN,
Counsel for Petitioner.

Duly verified.

EXHIBIT A

U. S. Treasury Department
Office of Regional Commissioner
Internal Revenue Service
123 U. S. Court House
Seattle 4, Washington

Aug. 25, 1954.

In Replying Refer to:

Ap:S:AA:90D
JEQ:MHB

Mrs. Grace H. Cunningham,
2026 Louisa Street,
Seattle, Washington.

Dear Mrs. Cunningham:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1946, discloses a deficiency of $6,725.59, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, Washington 4, D. C., for a redetermination of the deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia,

in which event that day is not counted as the 90th day. Otherwise Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to Assistant Regional Commissioner, Appellate, 123 United States Court House, Seattle 4, Washington. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiency and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is earlier.

Very truly yours,

T. COLEMAN ANDREWS,
Commissioner of Internal
Revenue;

By JAMES E. WESTIN,
Associate Chief,
Appellate Division.

Enclosures:
Statement
Form 1276
Agreement Form

Ap:S:AA:90D
JEQ:MHB

Statement

Mrs. Grace H. Cunningham
2026 Louisa Street
Seattle, Washington

Income Tax Liability for Taxable Year Ended December 31, 1946

Year	Deficiency
1946	$6,725.59

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated October 23, 1951; to your protest dated February 19, 1952; and to the statements made at the conferences held on April 9 and August 6, 1953.

A copy of this letter and statement has been mailed to your representative, Mr. Raymond D. Ogden, Jr., 460 Olympic National Building, Seattle, Washington, in accordance with the authority contained in the power of attorney executed by you.

Taxable Year Ended December 31, 1946
Adjustments to Net Income

Net income as disclosed by return, Form 1040	$31,354.94
Unallowable deductions and additional income:	
(a) Rental income	14,714.60
Net income as adjusted	$46,069.54

Explanation of Adjustments

(a) It is held that the cost of improvements placed in 1946 upon Lots 8, 9, 10, 11, and 12, Block 2102, Tacoma Land Company, Fifth Addition, Tacoma, Washington, by American Manufacturing Company, Inc., lessee, said lots being then owned by you, constituted taxable income to you in 1946 as lessor, to the extent of the fair market value subject to the lease, of such improvements, which, pursuant to the lease instrument, was to revert to you at the end of the six year term. The agreement by the lessee to convey and transfer to you all of its right, title and interest in such improvements at the end of the lease period

constituted the principal consideration for said lease. Since there was no taxable income reflected in the return from this source your reported net income has consequently been increased by the amount of $14,714.60, computed as follows:

Cost of improvements—1946	$21,904.33
Less: Depreciation for six-year term of lease at 2½% per year	3,285.66
Depreciated or adjusted basis Jan. 2, 1952	$18,618.67
Present value of $1.00 payable at end of six years at 4%	.790314
Fair market value of improvements January 2, 1946	$14,714.60

Computation of Alternative Tax

Net income as adjusted	$46,069.54
Minus excess of net long-term capital gain over net short-term capital loss	29,422.33
Ordinary net income	$16,647.21
Less exemptions	1,000.00
Normal tax and surtax net income	$15,647.21
Tentative normal tax and surtax	5,034.19
Less 5 per cent of $5,034.19	251.71
Partial tax	$ 4,782.48
Plus 50 per cent of $29,422.33	14,711.17
Total tax	$19,493.65
Less income tax payments to a foreign country	11.25
Income tax liability	$19,482.40
Liability disclosed by return, Orig. Acct. No. 3018272	12,756.81
Deficiency in income tax	$ 6,725.59

Received and filed October 22, 1954, T.C.U.S.

Served October 22, 1954.

[Title of Tax Court and Cause.]

Docket No. 55090

ANSWER

Comes Now the Commissioner of Internal Revenue, by his attorney, Daniel A. Taylor, Chief Counsel, Internal Revenue Service, and for answer to the petition filed herein, admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.

2. Admits the allegations contained in paragraph 2 of the petition.

3. Admits the allegations contained in paragraph 3 of the petition.

4 (a) to (j), inclusive. Denies that the Commissioner erred in his determination of the deficiency as shown by the notice of deficiency from which the petitioner's appeal is taken. Specifically denies that he erred in the manner and form as alleged in paragraphs 4 (a) to (j), inclusive, of the petition.

5 (a, b, c). Admits that there was a written lease executed covering lots 8, 9, 10, 11 and 12, Block 2102, Tacoma Land Company, Fifth Addition, Pierce County, Washington, running between Grace H. Cunningham, as lessor, and the American Manufacturing Company, as lessee. Admits that the period of the lease was six years. Denies the remaining allegations contained in paragraph 5 (a, b, c) of the petition.

(d) For lack of sufficient knowledge or information upon the basis of which to form a belief as to the truth or falsity thereof, denies the allegations contained in paragraph 5 (d) of the petition.

(e), (f), (g, h), (i) and (j). Denies the allegations contained in paragraphs 5 (e), (f), (g, h), (i) and (j) of the petition.

6. Denies generally and specifically each and every allegation contained in the petition not hereinbefore specifically admitted, qualified or denied.

Wherefore, it is prayed that the petitioner's appeal be denied and that the respondent's determination of deficiency be in all respects approved.

/s/ DANIEL A. TAYLOR, W.H.P.
Chief Counsel, Internal
Revenue Service.

Of Counsel:

MELVIN L. SEARS,
Regional Counsel;

JOHN H. WELCH,
Special Attorney, Internal
Revenue Service.

Filed November 22, 1954, T.C.U.S.

[Title of Tax Court and Cause.]

Docket No. 55091

PETITION

The above-named petitioners hereby petition for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Ap:S:AA:90D-JEQ:MHB-JEQ:MH-Bloom:fb) dated August 25, 1954, and as a basis for his proceeding allege as follows:

1. The petitioners are husband and wife whose residence address is 2026 Louisa Street, Seattle, Washington. The return for the period here involved was filed with the District Director of Internal Revenue at Tacoma, Washington, formerly known as the Collector of Internal Revenue.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioners on August 25, 1954.

3. The taxes in controversy are alleged income for the calendar year of 1952 and in the amount of $9,528.54.

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) The Commissioner erred in adding to net income of the petitioners for the taxable year ending December 31, 1952, the sum of $18,071.06 as rental income which purported to represent the al-

leged fair market value of improvements erected by lessee on lessor's leased lands under the terms of a written lease.

(b) The Commissioner erred in holding that the improvements placed upon lessor's real property by lessee under terms of a written lease constituted either rental or taxable gain to the petitioners.

(c) The Commissioner erred in failing to find that the lease made no provision whatsoever for rental and that it was the agreement between the parties that there would be no rental other than payment of taxes.

(d) The Commissioner erred in failing to hold as a matter of law that the improvements erected by lessee became, by reason of being annexed to the freehold, the property of the taxpayers immediately upon completion of the improvements.

(e) The Commissioner erred in determining the fair market value of the improvements by using an arithmetical formula which gave no consideration to the many factors that go to make up fair market value.

(f) The Commissioner erred in failing to determine the amount of fair rental for the lands described in the lease for the period of the leasehold.

(g) The Commissioner erred in holding that the principal consideration for the lease was an agreement to transfer to petitioners all of lessee's improvements at the expiration of the lease.

(h) The Commissioner erred in not holding that the true consideration for the lease was the agreement on behalf of the lessee to pay taxes.

(i) The Commissioner erred in holding that there was a liquidation of lease rental in kind where under the terms of the lease no lease rental, other than taxes, was required.

(j) Under the facts in this case the Commissioner erred in assessing any deficiency on any ground whatsoever.

5. The facts upon which the petitioners rely as the basis of this proceeding are as follows:

(a, b, c) There was a written lease executed covering Lots 8, 9, 10, 11 and 12, Block 2102, Tacoma Land Company, Fifth Addition, Pierce County, Washington, running between Grace H. Cunningham, as lessor, and the American Manufacturing Company, as lessee, in which lease there was no provision for rent other than the payment of taxes. The period of the lease was six years. The minutes of the American Manufacturing Company relating to said lease specifically recite that there was to be no rent charged other than payment of taxes, which taxes averaged approximately $46 per month during the life of the lease. There was no statement in the lease nor in the minutes of the corporation, nor was it the intent of the parties that the building erected upon the leased premises by the lessee was in lieu of rent.

(d) The improvements erected by the lessee were unseverable and permanent improvements, the title to such improvements was at all times vested in the lessor immediately upon their attachment to the freehold.

(e) The fair market value is not that found by the mathematical formula presented by respondent but instead the fair market value was not in excess of $8,000.00.

(f) The six-year lease to which reference has heretofore been made was strictly a ground lease. The fair rental value for said lands covered by said lease as of 1946 did not exceed $10 per month.

(g, h) The principal consideration for the lease was payment of taxes by the lessee. The building was built for the exclusive use of the lessee. Upon the termination of the six-year lease, January, 1952, a new lease was executed between the same parties, in which the lessee agreed to pay $10 per month rent as well as all taxes and payment of insurance, thus negativing the conclusion of the Commissioner that the consideration for the six-year lease was the benefit the lessor would derive from ownership of the building.

(i) There was no provision in the lease that the building erected by the lessee was to be considered as liquidation in part or in whole of leased rental, nor were there any facts from which the Commissioner could rightfully conclude that it was the intention of the parties that the building erected by

the lessee on the leased land was to be considered as in lieu of rent. The only rental requirement was payment of taxes and they were properly paid to cover all promises by lessee as rental consideration for the leased premises. The payment of taxes was adequate rent for use of the property rented and there is nothing further in the dealings between landlord and tenant in this case to indicate any intention to contract for any further payments, directly or indirectly, or in the form of property improvements.

(j) The peaceful and unrestricted possession of the improvements erected upon the leased property, being Lots 8, 9, 10, 11 and 12 of Block 2102, Tacoma Land Company, Fifth Addition, Tacoma, Washington, by the American Manufacturing Company, Inc., lessee, passed to the petitioners on the 2nd day of January, 1952, that being the date of termination of the said six-year lease. The value of said improvements was not included in gross income for 1952 and was then and now is specifically exempt from taxation, under the provisions of U.S.C.A. Title 26, Paragraph 22 (b)(11).

6. Wherefore the petitioners pray that this Board may hear the proceeding and redetermine the deficiency alleged by the respondent Commissioner.

/s/ RAYMOND D. OGDEN,
Counsel for Petitioners;

/s/ C. L. STONE,
Counsel for Petitioners.

Duly verified.

EXHIBIT A

U. S. Treasury Department
Office of the Regional Commissioner
Internal Revenue Service
123 U. S. Court House
Seattle 4, Washington

Aug. 25, 1954.

In Replying Refer to:

Ap:S:AA:90D
JEQ:MHB

Mr. Eugene F. Cunningham and
Mrs. Grace H. Cunningham,
Husband and Wife,
2026 Louisa Street,
Seattle, Washington.

Dear Mr. and Mrs. Cunningham:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1952, discloses a deficiency of $9,528.54, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, Washington 4, D. C., for a redetermination of the deficiency. In counting the 90 days you may not

exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia, in which event that day is not counted as the 90th day. Otherwise Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to Assistant Regional Commissioner, Appellate, 123 United States Court House, Seattle 4, Washington. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is earlier.

Very truly yours,

T. COLEMAN ANDREWS,
Commissioner of Internal
Revenue;

By JAMES E. WESTIN,
Associate Chief, Appellate
Division.

Enclosures:
Statement
Form 1276
Agreement Form

Ap:S:AA:90D
JEQ:MHB

Statement

Mr. Eugene F. Cunningham and Mrs. Grace H. Cunningham
Husband and Wife
2026 Louisa Street
Seattle, Washington

Income tax liability for taxable year ended
December 31, 1952

Year	Deficiency
1952	$9,528.54

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated May 11, 1954; to your protest dated June 29, 1954; and to the statements made at the conference held on July 21, 1954.

A copy of this letter and statement has been mailed to your representative, Mr. Raymond D. Ogden, Jr., 460 Olympic National Building, Seattle, Washington, in accordance with the authority contained in the power of attorney executed by you.

Taxable Year Ended December 31, 1946
Adjustments to Net Income

Net income disclosed by return, Form 1040	$23,822.46
Unallowable deductions and additional income:	
(a) Rental income	18,071.06
Net income as adjusted	$41,893.52

Explanation of Adjustments

(a) It is held that the cost of improvements placed in 1946 upon Lots 8, 9, 10, 11, and 12, Block 2102, Tacoma Land Company, Fifth Addition, Tacoma, Washington, by American Manufacturing Company, Inc., lessee, said lots being then owned by Grace H. Cunningham, constituted taxable income to you in 1952 as lessor, to the extent of the fair market value of such improvements, which, pursuant to the lease instrument, reverted to you at the end of the six year term. The agreement by the

lessee to convey and transfer to you all of its right, title and interest in such improvements at the end of the lease period constituted the principal consideration for said lease. Since there was no taxable income reflected in the return from this source your reported 1952 net income has consequently been increased by the amount of $18,071.06, computed as follows:

Cost of improvements—1946	$21,904.33
Less: Depreciation for six-year term of lease at 2½% per year	3,285.66
Fair market value of improvements Jan. 2, 1952	$18,618.67
Less: Depreciation for 1952 on above improvements	547.61
Increase in income	$18,071.06

Computation of Tax

Net income as adjusted	$41,893.52
Less exemptions	1,800.00
Balance	$40,093.52
One-half of balance	20,046.76
Combined normal tax and surtax	8,144.99
Combined normal tax and surtax multiplied by two	16,289.98
Add self-employment tax	81.00
Total tax liability	$16,370.98
Liability disclosed by return, Orig. Acct. No. AF 712824	6,842.44
Deficiency in income tax	$ 9,528.54

Received and filed October 22, 1954, T.C.U.S.

Served October 22, 1954.

[Title of Tax Court and Cause.]

Docket No. 55091

ANSWER

Comes Now the Commissioner of Internal Revenue, by his attorney, Daniel A. Taylor, Chief Counsel, Internal Revenue Service, and for answer to the petition filed herein, admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.

2. Admits the allegations contained in paragraph 2 of the petition.

3. Admits the allegations contained in paragraph 3 of the petition.

4 (a) to (j), inclusive. Denies that the Commissioner erred in his determination of the deficiency as shown by the notice of deficiency from which the petitioners' appeal is taken. Specifically denies that he erred in the manner and form as alleged in paragraphs 4 (a) to (j), inclusive, of the petition.

5 (a, b, c). Admits that there was a written lease executed covering Lots 8, 9, 10, 11 and 12, Block 2102, Tacoma Land Company, Fifth Addition, Pierce County, Washington, running between Grace H. Cunningham, as lessor, and the American Manufacturing Company, as lessee. Admits that the period of the lease was six years. Denies the remaining allegations contained in paragraph 5 (a, b, c) of the petition.

(d) For lack of sufficient knowledge or information upon the basis of which to form a belief as to the truth or falsity thereof, denies the allegations contained in paragraph 5 (d) of the petition.

(e), (f), (g, h), (i) Denies the allegations contained in paragraphs 5 (e) ,(f) (g, h) and (i) of the petition.

(j) Admits that the peaceful and unrestricted possession of the improvements erected upon the leased property, being Lots 8, 9, 10, 11 and 12 of Block 2102, Tacoma Land Company, Fifth Addition, Tacoma, Washington, by the American Manufacturing Company, Inc., lessee, passed to petitioners on the 2nd day of January, 1952, that being the date of termination of the said six-year lease. Admits that the value of said improvements was not included in gross income for 1952. Denies the remaining allegations contained in paragraph 5 (j) of the petition.

6. Denies generally and specifically each and every allegation contained in the petition not hereinbefore specifically admitted, qualified or denied.

Wherefore, it is prayed that the petitioners' appeal be denied and that the respondent's determination of deficiency be in all respects approved.

/s/ DANIEL A. TAYLOR, W.H.P.
Chief Counsel, Internal
Revenue Service.

Of Counsel:

MELVIN L. SEARS,
Regional Counsel;

JOHN H. WELCH,
Special Attorney, Internal
Revenue Service.

Filed November 22, 1954, T.C.U.S.

[Title of Tax Court and Cause.]

FINDINGS OF FACT AND OPINION

Docket Nos. 55090, 55091

Improvements by Lessee on Lessor's Property. Sections 22(a) and 22(b)(11), Internal Revenue Code of 1939—The owner of real estate leased the property to a corporation of which she was a principay stockholder, manager and financial backer. Under the lease the corporation was to make certain improvements upon the lots, pay the taxes on the property, and transfer title to the improvements to the lessor at the termination of the lease. The evidence establishes that the parties did not intend that the value of the improvements should constitute rent, but that the improvements were intended to benefit the business of the corporation. Held, that the petitioners did not realize taxable income as a result of such improvements either at the time of

construction thereof or upon termination of the lease.

RAYMOND D. OGDEN, ESQ.,
For the Petitioners.

JOHN H. WELCH, ESQ.,
For the Respondent.

Atkins, Judge:

The respondent determined deficiencies in income tax for the years 1946 and 1952 in the respective amounts of $6,725.59 and $9,528.54. The question presented for decision is whether any amount should be included in gross income of the petitioners in either 1946 or 1952, on account of improvements constructed in 1946 by a lessee under a six-year lease expiring in 1952, and, if so, the amount to be included.

Findings of Fact

Some of the facts are stipulated and are so found, the stipulation being incorporated herein by this reference.

The petitioners are husband and wife residing in Seattle, Washington. The petitioner, Grace H. Cunningham, filed her income tax return for the year 1946 with the collector of internal revenue at Tacoma, Washington. The two petitioners filed a joint income tax return for the year 1952 with the director of internal revenue at Tacoma, Washington. Here-

inafter the term "petitioner" refers to the petitioner, Grace H. Cunningham.[1]

The petitioner in 1928 started a steel manufacturing enterprise which was incorporated in 1936 as the American Manufacturing Company, Inc. She has continuously been one of the principal owners of the stock and its general manager and financial backer. Her brother, T. M. Gepford, has been and now is president and executive head of the company. Her husband, the petitioner, Eugene F. Cunningham, has been vice president and a member of the board of directors. The company is in the business of manufacturing heavy machinery.

The property of the American Manufacturing Company is situated in block 2103 of the Tacoma Land Company's Fifth Addition in the City of Tacoma. Immediately to the east of such property, and separated therefrom by an alley 40 feet in width, are situated lots 7 to 12, inclusive, of block 2102, which in 1936 were owned by Martin A. and Mary E. Petrich. At that time those lots were not level, in some places being as much as 30 to 40 feet below grade, and had little usable surface. For many years they had constituted a dumping ground for rubbish and scrap. In 1936 American Manufacturing Company under an oral agreement with

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[1]In 1946 the petitioner, Grace H. Cunningham, held certain lots involved herein as her sole and separate property, but at some time prior to January 1, 1952, such lots, except one which had been sold, were converted to community property by proper instruments of conveyance.

the owners acquired the right to use those lots for open storage of steel and other materials and to make such fills thereon as might be necessary. By 1943 or 1944 the lots had been filled so as to become usable over their entire area. The American Manufacturing Company did not, up to that time, pay any rent or taxes thereon. For a portion of 1943 it paid $10 per month for the use of lots 8 to 12 under an oral agreement after having installed an annealing oven on a portion of lots 8 to 12. The American Manufacturing Company agreed at that time to remove the annealing oven as soon as its use was terminated.

In 1943 the American Manufacturing Company erected a craneway on lot 9 of block 2102 to be used for the moving of heavy equipment. The dimensions of lot 9 are 25 feet by 120 feet. A slab of cement 25 feet in width and approximately 60 feet in length was laid down and the craneway was then erected of wood with columns running the full length of 120 feet.

The company was still in need of additional working space for steel cutting equipment. In October, 1944, the company owed a bank $41,000. At January 1, 1946, it owed banks about $172,000 and Cunningham Steel Foundry (owned by the petitioner, Eugene F. Cunningham) $25,000. At the end of 1946 it owed banks about $184,000. The petitioner was endorser and guarantor of the bank loans.

On October 26, 1944, the petitioner purchased lots 7 to 12 of block 2102 at a price of $8,000. At that

time the American Manufacturing Company was expanding rapidly. Immediately following the purchase of the property by the petitioner, the American Manufacturing Company at its own cost placed an adequate roof over the superstructure of the craneway and also enclosed the entire south side of the craneway, 120 feet, with large windows supported by hollow cement tile blocks. This constituted the cheapest type of construction permitted by the building code of the City of Tacoma.

In November, 1945, the petitioner, Eugene F. Cunningham, desired to erect a warehouse building on lots 4, 5 and 6 of block 2102. The petitioner, Grace H. Cunningham, had no interest in such lots nor in the building to be constructed thereon. Petitioner Eugene F. Cunningham needed more area for the contemplated building and purchased lot 7 of block 2102 from the petitioner for $1,333.33. He then erected a cement warehouse building 120 feet long and 100 feet wide, known as the Graybar Building, which was ready for occupancy by May, 1946. The southerly wall of the building constituted the dividing line between lots 7 and 8.

The petitioner, being the largest stockholder and manager of American Manufacturing Company, was desirous of permitting the company to expand its business and obtain the necessary room by changing the craneway into a complete structure. In the latter part of December, 1945, she entered into an oral lease with the American Manufacturing Company covering lots 8 to 12 of block 2102. It was agreed

that the American Manufacturing Company could use lot 8 which adjoined the Graybar Building and lot 9 for the purpose of enclosing both lots 8 and 9 as one large area 50 feet by 120 feet, this to be done by closing the two 50-foot ends by use of large doors and using the south wall of the Graybar Building as the north wall of the enclosure. The terms of this oral lease are substantially set forth in the minutes of a meeting of the board of directors of the American Manufacturing Company held on December 15, 1945. Such minutes contain the following:

> * * * The President also announced that said Grace H. Cunningham was desirous of leasing said property to the American Manufacturing Company, Inc., on the following basis:

That the American Manufacturing Company would construct a building on said property at its own expense; would pay all the taxes, and at the end of a six-year period, said lease would be terminated and the building on the property would revert to the owner of the real property, Grace H. Cunningham. That there would be no rent paid for said lease but that the consideration for the lease was the transfer of the building to Grace H. Cunningham at the end of the term of the lease. Therefore, after full discussion having been had, the following resolution was unanimously adopted:

"Be It Resolved, that the proper officers of the American Manufacturing Company, Inc., be instructed to prepare the proper instruments to lease

from Grace H. Cunningham, Lots 8, 9, 10, 11 and 12, Block 2102, Tacoma Land Company, Fifth Addition, Tacoma, Washington, for a period of six years commencing with the 2nd day of January, 1946. That the terms and conditions of said lease be such that the consideration for said lease would be the transfer of any and all interests that the American Manufacturing Company, Inc., had in the building to be constructed on the premises to be transferred to Grace H. Cunningham. That American Manufacturing Company, Inc., would immediately commence construction of a building on said premises of the approximate value of $25,000.00. That the proper officers of the American Manufacturing Company, Inc., also be instructed to pay the taxes on said property for the term of the lease."

The lease was later reduced to writing in a written lease dated March 17, 1947. Such lease provides for a term of six years from January 2, 1946, to January 2, 1952. Therein it is recited:

> * * * The consideration for said lease being that the lessee will pay taxes on the above-described property for a period of six years and will transfer, at the end of the period of the lease, all right, title and interest which said lessee has in a building which lessee has constructed and paid for on the above-described property.
>
> * * *
>
> And at the expiration of said term, the said lessee will quit and surrender the said premises

in good state and condition as they now are (ordinary wear and damage by the elements or fire excepted).

Prior to January 1, 1946, the American Manufacturing Company had expended $2,800 for roofing of the craneway on lot 9 and the enclosure of the south wall with hollow tile and glass windows, and $2,755 for grading and paving the alley. Subsequent to the effective date of the lease, January 2, 1946, the American Manufacturing Company expended $11,097 as cost of improvements which, pursuant to the lease, were to revert to the petitioner at the end of the lease period. Another craneway was built located on lot 8, next to the Graybar Building, a floor was laid, a roof was constructed over lot 8 (resulting in a roof over both lots 8 and 9), and doors were installed at the ends of the structure located on both lots 8 and 9. The improvements placed upon the property by the American Manufacturing Company which under the terms of the lease were to revert to the petitioner are improvements attached to the realty.

On March 29, 1946, the petitioner, Eugene F. Cunningham, as first party and the petitioner, and the American Manufacturing Company, Inc., as second parties, entered into a party wall agreement. It was therein recited that the parties are the owners of adjoining pieces of property. Therein it was agreed that the south wall of the Graybar Building should be thereafter the common property of the parties to the agreement and that the covenants contained

in the agreement should run with the land. Since the Graybar Building was not as tall as the building on the petitioner's lots, it was necessary to extend the height of the wall by several feet. The party wall was completed in 1946 at some time prior to the execution of the party wall agreement on March 29, 1946. The American Manufacturing Company paid an amount of $4,734 in connection with the party wall. The party wall agreement was made as a part of or in connection with the oral lease.

On January 2, 1952, the American Manufacturing Company released all right, title and interest in and to the improvements, to the petitioner. This release did not change or purport to change the rights of the parties under the party wall agreement.

On January 14, 1952, the petitioners, as husband and wife and as a community, executed a new lease with the American Manufacturing Company covering lots 8 and 9 and the east 40 feet of lot 10 in block 2102, together with improvements for a period of 10 years from and after January 1, 1952. The lessee agreed to pay $10 per month and all taxes of every kind against the property and any and all other expenses of any kind or character incident to the occupation or maintenance of the premises. The lessee agreed that any additions or repairs or improvements placed upon the building should, at the expiration of the lease, become the property of the lessors. It further agreed to keep the building fully insured in an amount satisfactory to the lessors.

Since January 1, 1952, the American Manufacturing Company has paid rent of $10 per month, together with taxes, for lots 8 and 9 and the east 40 feet of lot 10 of block 2102.

The only specified cash rent as such that was ever paid up to January 1, 1952, for the use of any part of the properties was $10 per month for a portion of the year 1943, which was prior to the time the petitioner purchased lots 8 to 12.

The American Manufacturing Company capitalized the total cost of improvements on these lots at $21,904.33 on its books and corporation income tax returns, and claimed a depreciation deduction of one-sixth of that amount in each of the taxable years 1946 to 1951, inclusive.

The assessed valuation of the lots, exclusive of improvements, as determined by the county assessor for the various years involved in the first lease period was $2,800 and the average rate of taxation during such period was roughly 6.5 per cent. The average annual tax during such period, exclusive of improvements, was $182. The taxes on lots 8 to 12, inclusive, including improvements, for the years 1946 to 1950, were as follows:

1946—paid in 1947	$218.11
1947—paid in 1948	677.11
1948—paid in 1949	588.46
1949—paid in 1950	689.63
1950—paid in 1951	620.71

The annual cost of insurance was $66.66. The policy does not protect the petitioner nor does she carry insurance on the property.

In determining the deficiency for the year 1946 the respondent added to reported taxable income the amount of $14,714.60 as rental income, stating that "the cost of improvements placed in 1946 upon Lots 8, 9, 10, 11 and 12 * * * constituted taxable income to you in 1946 as lessor, to the extent of the fair market value subject to the lease, of such improvements, which, pursuant to the lease instrument, was to revert to you at the end of the six-year term." His computation of the amount of $14,714.60 was as follows:

Cost of improvements—1946	$21,904.33
Less: Depreciation for six-year term of lease at 2½% per year	3,285.66
Depreciated or adjusted basis Jan. 2, 1952	$18,618.67
Present value of $1.00 payable at end of six years at 4%	.790314
Fair market value of improvements January 2, 1946	$14,714.60

In determining the deficiency for the year 1952 the respondent added to reported taxable income the amount of $18,071.06 as rental income, stating that "the cost of improvements * * * constituted taxable income to you in 1952 as lessor, to the extent of the

fair market value of such improvements, which, pursuant to the lease instrument, reverted to you at the end of the six-year term." The amount of $18,071.06 was computed by the respondent as follows:

Cost of improvements—1946	$21,904.33
Less: Depreciation for six-year term of lease at 2½% per year	3,285.66
Fair market value of improvements Jan. 2, 1952	$18,618.67
Less: Depreciation for 1952 on above improvements	547.61
Increase in income	$18,071.06

Included in the above cost of $21,904.33 is the amount of $4,734 paid by the American Manufacturing Company to constitute the south wall of the Graybar Building, a party wall. Also included is the amount of $2,755, the cost of construction and hard-surfacing of the alley. This $2,755 does not constitute a proper part of the cost of the building.

The parties to the lease did not intend that the value of the improvements made by the lessee should, and it did not, represent, in whole or in part, rent at the time of construction or at the termination of the lease.

Opinion

The question presented for decision is whether income was derived either by the petitioner, Grace H. Cunningham in 1946 when the lessee, American

Manufacturing Company, made improvements on her property, or by her and her husband, the petitioner, Eugene F. Cunningham, on account thereof in 1952 at the termination of the lease, at which time the property was held as community property. There is not before us for decision any question as to whether taxable income was derived by the petitioners as a result of other requirements of the lease such as the payment by the lessee of taxes on the property.

The respondent concedes that in determining deficiencies for both 1946 and 1952 he has acted inconsistently and that income was derived in only one year, contending primarily that the proper year was 1946, but in the alternative that income was derived in 1952.

The petitioners contend that under the circumstances here presented no income was derived in either year. Alternatively, they contend that income could have been derived only in 1952 and that the amount of income has been erroneously computed.

We are concerned with sections 22(a) and 22(b)(11) of the Internal Revenue Code of 1939. Section 22(a) provides:

> General Definition—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of

any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

Section 22(b)(11) provides:

> Exclusions from Gross Income—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:
>
> * * *
>
> Improvements by lessee on lessor's property —Income, other than rent, derived by a lessor of real property upon the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by the lessee.

The question of whether and when a lessor derives taxable income as a result of improvements made by a lessee has, through the years, been a troublesome one and has been the subject of much litigation and also of legislation. A brief discussion of the historical background is helpful.

In M. E. Blatt Co. v. U. S., 305 U.S. 267 (1938), the owner of real estate leased the property in 1930

for use as a moving picture theater for a term of 10 years, beginning upon completion of improvements to be made. The lessor agreed to make certain alterations and the lessee agreed to install the latest type of moving picture apparatus and other furniture and equipment necessary for the successful operation of a modern theater, to become the property of the lessor at the expiration, or sooner termination, of the lease. The lessee agreed to pay for certain of the improvements. The Commissioner added to the taxpayer's income for the first year of the lease one-tenth of the estimated depreciated value at the termination of the lease of the alterations and improvements paid for by the lessee. The Supreme Court held that no income was derived in such year either as rental or otherwise, stating in part:

There is nothing in the findings to suggest that cost of any improvement made by lessee was rent or an expenditure not properly to be attributed to its capital or maintenance account as distinguished from operating expense. While the lease required it to make improvements necessary for successful operation, no item was specified, nor the time or amount of any expenditure. The requirement was one making for success of the business to be done on the leased premises. It well may have been deemed by lessor essential or appropriate to secure payment of the rent stipulated in the lease. Even when required, improvements by lessee will not be deemed rent unless intention that they shall be is plainly disclosed. Rent is "a fixed sum, or property amount-

ing to a fixed sum, to be paid at stated times for the use of property * * *; it does not include payments, uncertain both as to amount and time, made for the cost of improvements * * *." The facts found are clearly not sufficient to sustain the lower court's holding to the effect that the making of improvements by lessee was payment of rent.

It remains to be considered whether the amount in question represented taxable income, other than rent, in the first year of the term.

* * *

Granting that the improvements increased the value of the building, that enhancement is not realized income of lessor. So far as concerns taxable income, the value of the improvements is not distinguishable from excess, if any there may be, of value over cost of improvements made by lessor. Each was an addition to capital; not income within the meaning of the statute. Treasury Regulations can add nothing to income as defined by Congress.

But, assuming that at some time value of the improvements would be income of lessor, it cannot be reasonably assigned to the year in which they were installed. The commissioner found that at the end of the term some would be worthless and excluded them. He also excluded depreciation of other items. These exclusions imply that elements which will not outlast lessee's right to use are not at any time income of lessor. The inclusion of the remaining value is to hold that petitioner's right to have them as a part of the building at expiration of lease consti-

tutes income in the first year of the term in an amount equal to their estimated value at the end of the term without any deduction to obtain present worth as of date of installation. It may be assumed that, subject to the lease, lessor became owner of the improvements at the time they were made. But it had no right to use or dispose of them during the term. Mere acquisition of that sort did not amount to contemporaneous realization of gain within the meaning of the statute.

In Helvering v. Bruun, 309 U.S. 461 (1940), the taxpayer as owner had in 1915 leased land and a building thereon for a term of 99 years. The lessee had the right under certain conditions to remove buildings, provided that no building should be removed or torn down after the lease became forfeited or during the last three and one-half years of the term. The lessee was to surrender the land, upon termination of the lease, with all buildings and improvements thereon. In 1929 the lessee removed the existing building and constructed a new one. In 1933 the lease was cancelled for default and the lessor regained possession of the land and building. The Commissioner determined that in 1933 the taxpayer realized a net gain in the amount of the net fair market value of the new building. In that case the Supreme Court upheld that determination, stating in part:

The course of administrative practice and judicial decision in respect of the question presented has not been uniform. In 1917 the Treasury ruled that the

adjusted value of improvements installed upon leased premises is income to the lessor upon the termination of the lease. The ruling was incorporated in two succeeding editions of the Treasury Regulations. In 1919 the Circuit Court of Appeals for the Ninth Circuit held in Miller v. Gearin, 258 F. 225, that the regulation was invalid as the gain, if taxable at all, must be taxed as of the year when the improvements were completed.

The regulations were accordingly amended to impose a tax upon the gain in the year of completion of the improvements, measured by their anticipated value at the termination of the lease and discounted for the duration of the lease. Subsequently the regulations permitted the lessor to spread the depreciated value of the improvements over the remaining life of the lease, reporting an aliquot part each year, with provision that, upon premature termination, a tax should be imposed upon the excess of the then value of the improvements over the amount theretofore returned.

In 1935 the Circuit Court of Appeals for the Second Circuit decided in Hewitt Realty Co. v. Commissioner, 76 F. 2d 880 * * * that a landlord received no taxable income in a year, during the term of the lease, in which his tenant erected a building on the leased land. The court, while recognizing that the lessor need not receive money to be taxable, based its decision that no taxable gain was realized in that case on the fact that the improvement was not portable or detachable from the

land, and if removed would be worthless except as bricks, iron, and mortar. * * *

This decision invalidated the regulations then in force.

* * *

The circumstance of the instant case differentiate it from the Blatt and Hewitt cases; but the petitioner's [Commissioner's] contention that gain was realized when the respondent [the taxpayer], through forfeiture of the lease, obtained untrammeled title, possession and control of the premises, with the added increment of value added by the new building, runs counter to the decision in the Miller case and to the reasoning in the Hewitt case.

* * *

We hold that the petitioner was right in assessing the gain as realized in 1933.

* * *

The respondent cannot successfully contend that the definition of gross income in Sec. 22(a) of the Revenue Act of 1932 is not broad enough to embrace the gain in question. That definition follows closely the Sixteenth Amendment. * * *

* * *

Here, as a result of a business transaction, the respondent received back his land with a new building on it, which added an ascertainable amount to its value. It is not necessary to recognition of taxable gain that he should be able to sever the improvement begetting the gain from his original capital. * * *

After the Supreme Court's decision in the Bruun case there remained no question that the value of improvements made by a lessee constituted taxable income to the lessor, under the broad definition of income contained in section 22(a), at the date of termination of the lease. Lewis v. Pope Estate Co. (C.A. 9, 1940), 116 F. 2d 328, cert. denied, 314 U.S. 630; Greenwood Packing Plant v. Commissioner (C.A. 4, 1942), 131 F. 2d 787; and Trask v. Hoey (C.A. 2, 1949), 177 F. 2d 940.[2]

Thereafter, however, Congress, by section 101 of the Revenue Act of 1942, enacted section 22(b)(11), quoted hereinabove, to modify the effect of the Bruun case by limiting the recognition of income on termination of the lease to that which constituted rent.[3]

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[2]Treasury Decision 4980, 1940-2 C.B. 42, was promulgated on July 2, 1940, amending section 19.22 (a)-13 of Regulations 103 to read in part as follows:

Improvements by lessee—If buildings are erected or other improvements are made by a lessee, the lessor shall include in gross income as of the date he acquires possession or control of the real estate with such improvements thereon, at the termination of the lease by forfeiture or otherwise, an amount equal to the excess of the value as of such date of the real estate with such improvements thereon over the value as of such date of the real estate without such improvements.

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[3]The Ways and Means Committee Report (H. Rept. No. 2333, 77th Cong., 2nd Sess.) and the Finance Committee Report (S. Rept. No. 1631, 77th Cong., 2nd Sess.), state as follows, 1942-2 C.B. 425:

In Helvering v. Bruun (309 U.S. 461 (1940) * * *) it was held that buildings or other improvements

The Revenue Act of 1942 also added subsection (c) to section 113 of the Internal Revenue Code to provide that the basis of real property should not be increased or diminished on account of income derived by a lessor and excludible from gross income under section 22(b)(11).

Section 29.22(b)(11)-1 of Regulations 111, promulgated under section 22(b)(11) of the 1939 Code, as amended, provides in part:

> Sec. 29.22(b)(11)-1. Exclusion from Gross Income of Lessor of Real Property of Value of Improvements Erected by Lessee—Income derived by a lessor of real property upon the termination, through forfeiture or otherwise, of the lease of such property and attributable to buildings erected or other improvements made by the lessee upon the leased property is excluded from gross income. However, where the

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made by a lessee constitute income to a lessor to the extent of the value of such improvements at the time the lease is forfeited and the lessor secures control and possession of the property. Your committee believes it advisable to exclude (except in cases in which such improvements represent a liquidation in kind of lease rentals) from the gross income of the lessor income attributable to such improvements. Such exclusion from gross income of the lessor does not mean that the enhancement in value in the hands of the lessor will not be ultimately taxed. By reason of the fact that the gross income attributable to the value of the improvements is not recognized, the basis of the property in the hands of the lessor will not be increased by such item.

> facts disclose that such buildings or improvements represent in whole or in part a liquidation in kind of lease rentals, the exclusion from gross income shall not apply to the extent that such buildings or improvements represent such liquidation. The exclusion applies only with respect to the income realized by the lessor upon the termination of the lease and has no application to income, if any, in the form of rent, which may be derived by a lessor during the period of the lease and attributable to buildings erected or other improvements made by the lessee. * * *

Such regulations, including an example set forth therein, clearly indicate that neither at the termination of a lease nor at any time during the period of the lease does a lessor derive taxable income as a result of improvements upon leased premises, unless the income attributable to them constitutes rental income. On the other hand regulations do in effect provide that taxable income may be derived by a lessor on account of improvements by the lessee during the period of the lease if any such income represents rental. It is apparently upon the basis of this regulation that the respondent makes his principal contention that the petitioner in the instant case derived income in 1946 from the construction of the improvements. The petitioner argues strongly that under the authorities set forth hereinabove a lessor may not be considered as deriving income prior to termination of the lease, whether as rent or otherwise.

In the view we take of the instant case, we find it unnecessary to decide that question. It is clear that neither the statute nor the regulations purport to treat as taxable income to the lessor at any time the value of improvements unless such value represents rent.

In M. E. Blatt Co. v. U. S., supra, the Supreme Court has clearly stated that whether the value of such improvements constitutes rent depends upon the intention of the parties, and that even when the improvements are required by the terms of the lease this value will not be deemed rent unless the intention that it shall be such is plainly disclosed. Such intent in our opinion is to be derived not only from the terms of the lease but from the surrounding circumstances. This is recognized by the respondent in his published ruling I.T. 4009, 1950-1 C.B. 13.

In the instant case, while the lease, both in its oral and written form, provides that the consideration for the lease was to be in part the transfer, at the end of the term of the lease, of the building to the petitioner, we note that the contemporaneous construction of the lease by the directors, as shown in their minutes is that there would be no rent paid for the lease. Consistently, the company, as lessee, did not treat the cost of the improvements as rental, but treated such cost on its books and in its income tax returns as a capital outlay and amortized it over the term of the lease.

The petitioner, Grace H. Cunningham, in 1928 started the steel manufacturing enterprise which

was incorporated in 1936 as the American Manufacturing Company, Inc. She was one of the principal stockholders, and its manager and financial backer, and had endorsed and guaranteed its bank loans, amounting at one time to about $184,000. Her brother was president and her husband, Eugene F. Cunningham, was vice president. At the time the petitioner purchased the land and entered into the lease the company was in dire need of room for expansion. It had previously used the lots for outdoor storage without paying rental to the prior owners, except a nominal rental for a portion of the year 1943. After the petitioner acquired the property and before the oral lease was entered into, the company placed a roof over the craneway and enclosed one side thereof. After the date of the lease it continued to make other improvements to this structure as described in the findings of fact.

The petitioner testified that the reason she bought the lots and leased them to the company was in order that her company would have working space in that locality and not be forced to move, and that she had no intention of charging rent. She stated that the company was to use the lots for nothing, provided it payed the taxes. She also testified that she considered the improvements to be of a special type of construction to meet the particular need of the business of the company, that they did not have any value to anyone else except some one in a similar manufacturing business and that there was no other company in the city doing similar manufacturing. She stated that as the property

owner she did not consider that the improvements had any value and that if she had not been connected with the company she would have required an agreement on the part of the lessee to remove the improvements. The petitioner, Eugene F. Cunningham, testified that in 1945 the company was not in a financial position to buy the lots. When the lease terminated in 1952 and title to the improvements was acquired by the petitioners, they entered into a new written lease with the company covering substantially the same properties for a period of 10 years at an agreed rental of $10 per month, the lessee to pay all taxes and maintenance and any new improvements to become the property of the lessors at the end of the term.

We are satisfied from this testimony and from the acts of the parties to the lease that they did not intend that the value of the improvements should constitute rent either at the time of construction or at the termination of the lease. We have therefore concluded and found as a fact that the value of such improvements made by the lessee did not represent rent at the time of construction or upon termination of the lease. It follows that the petitioners did not derive income attributable to such improvements either in 1946 or in 1952.

Decision will be entered for the petitioners.

Served June 17, 1957.

Entered June 17, 1957.

Filed June 17, 1957.

Tax Court of the United States
Washington

Docket No. 55090

GRACE H. CUNNINGHAM,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion filed June 17, 1957, it is

Ordered and Decided: That there is no deficiency in income tax for the calendar year 1946.

/s/ CRAIG S. ATKINS,
Judge.

Served June 26, 1957.

Entered June 26, 1957.

Tax Court of the United States
Washington

Docket No. 55091

EUGENE F. CUNNINGHAM and GRACE H. CUNNINGHAM, Husband and Wife,

Petitioners,

vs.

COMMISSIONER OF INTERAL REVENUE,

Respondent.

DECISION

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion filed June 17, 1957, it is

Ordered and Decided: That there is no deficiency in income tax for the calendar year 1952.

/s/ CRAIG S. ATKINS,
Judge.

Served June 26, 1957.

Entered June 26, 1957.

[Title of Tax Court and Cause.]

Docket Nos. 55090 and 55091

STIPULATION OF FACTS

It is hereby stipulated and agreed between the Commissioner of Internal Revenue and the above-

entitled taxpayers, by their respective undersigned attorneys, that the following facts shall be taken as true, provided, however, that this stipulation does not waive the right of either party to introduce other evidence not at variance with the facts herein stipulated.

1. Petitioners, Eugene F. Cunningham and Grace H. Cunningham, are husband and wife, residing at 2026 Louisa Street, Seattle, Washington. The above-captioned proceedings may be consolidated for the purposes of trial and opinion, as similar issues are involved in each proceeding. The deficiency letter in Docket No. 55090 states as follows:

"Explanation of Adjustments:

"(a) It is held that the cost of improvements placed in 1946 upon Lots 8, 9, 10, 11 and 12, Block 2102, Tacoma Land Company, Fifth Addition, Tacoma, Washington, by American Manufacturing Company, Inc., lessee, said lots being then owned by you, constituted taxable income to you in 1946 as lessor, to the extent of the fair market value subject to the lease, of such improvements, which, pursuant to the lease instrument, was to revert to you at the end of the six-year term."

The deficiency letter in Docket No. 55091 states as follows:

"Explanation of Adjustments:

"(a) It is held that the cost of improvements placed in 1946 upon Lots 8, 9, 10, 11 and

12, Block 2102, Tacoma Land Company, Fifth Addition, Tacoma, Washington, by American Manufacturing Company, Inc., lessee, said lots being then owned by Grace H. Cunningham, constituted taxable income to you in 1952 as lessor, to the extent of the fair market value of such improvements, which, pursuant to the lease instrument, reverted to you at the end of the six year term."

The same property and improvements are involved in each proceeding and the determinations are inconsistent. The matter is left for the Court to decide whether the cost of improvements constitutes taxable income, and if so, whether such cost, if at all, becomes income for 1946 or 1952. In view of the situation hereinabove set forth the facts herein stipulated apply with equal force to both cases.

2. The deficiency letter in each proceeding was mailed on August 25, 1954, and petitioners were advised of respondent's determination of deficiencies in income tax, the entire amounts of which are in controversy. The deficiencies so involved are as follows:

Docket No.	Taxable Year	Amount
55090	1946	$6,725.59
55091	1952	$9,528.54

3. Petitioner, Grace H. Cunningham, has been one of the principal owners of the stock of the American Manufacturing Company, a Washington corporation, since the date of its incorporation in

1936, and has continuously been an official and active in the management thereof. Her brother, T. M. Gepford, has been and now is president and executive head of the company. The company at all times has been engaged in the manufacture of heavy machinery.

4. In, 1936 and for some years prior thereto, Martin A. Petrich and Mary E. Petrich, husband and wife, and Leo J. Hunt and Louise G. Hunt, husband and wife, were the owners of Lots 7 to 12, inclusive, of Block 2102, Map of New Tacoma, Washington Territory. The property of the American Manufacturing Company was situated in Block 2103 which lies immediately to the west of said Lots 7 to 12 and separated therefrom by an alley 40 feet in width. Said Lots 7 to 12 are each 25 feet wide and 120 feet long.

5. In 1936 pursuant to an oral agreement between the American Manufacturing Company and the owners of said lots, the American Manufacturing Company acquired the right to use so much of said lots as were susceptible of use for open storage of steel and other like materials used by the American Manufacturing Company in the operation of its business and with the right to make such fills on the lots as the American Manufacturing Company found necessary or useful in their occupation and use of the lots.

6. The American Manufacturing Company was to pay no rent and no taxes; this condition con-

tinued until 1943 at which time the American Manufacturing Company desired to build an annealing oven on a portion of said lots. Thereupon a second oral agreement was entered into with the owners of the lots to the effect that the American Manufacturing Company could install an annealing oven on the property but would be required to pay a rental of $10.00 a month, and to further agree to remove the annealing oven as soon as its use was terminated.

7. In the year 1943 the American Manufacturing Company was also desirous of erecting a craneway on lot 9. This the company did by laying down a cement slab 25 feet in width and approximately 60 feet in length. Lot 9 is 25 feet by 120 feet. The craneway was a wooden structure with supporting columns running the full length of the 120 feet. The pillars were of sufficient strength to bear the superstructure of the craneway. The craneway was to be used for the moving of heavy equipment.

8. On October 26, 1944, petitioner Grace H. Cunningham purchased lots 7 to 12, inclusive, of said block 2102 at a price of $8,000.00. At that time the American Manufacturing Company was expanding rapidly. Immediately following the purchase of the property by Petitioner Grace H. Cunningham, the American Manufacturing Company at its own cost placed an adequate roof over the superstructure of the craneway, and also enclosed the entire south side of said craneway by the use of large windows, 17 feet by 18 feet, supported by hollow cement tile blocks. The windows were placed between the sup-

porting wooden columns thus enclosing the entire south side, a distance of 120 feet, thus protecting the workmen from inclement weather, the prevailing winds and storms coming from the south.

9. In November of 1945 Petitioner Eugene F. Cunningham, husband of the taxpayer, desired to erect a warehouse building on Lots 4, 5 and 6 of said Block 2102. Petitioner Grace H. Cunningham had no interest in said lots, nor in the building to be constructed thereon. Petitioner Eugene F. Cunningham needed more area for the contemplated building and to that end did purchase from taxpayer Lot 7 in said Block 2102 for the price of $1,333.33, being 1/5 of $8,000.00 original purchase price. Eugene F. Cunningham then proceeded with the erection of the cement warehouse building, had the same ready for occupancy by May of 1946. This building was known as the Graybar Building. The Graybar Building was 120 feet long and 100 feet wide. The southerly wall of the building constituted the dividing line between Lots 7 and 8. The length of the wall being 120 feet running from A Street on the east to the alley on the west.

10. In the latter part of December, 1945, American Manufacturing Company entered into an oral lease with the taxpayer covering lots 8 to 12, inclusive, of said Block 2102, the terms of which lease provided that the American Manufacturing Company could use Lot 8, which adjoined the Graybar Building, and Lot 9, for the purpose of enclosing

both Lots 8 and 9 as one large area 50 feet by 120 feet. This to be done by closing the two 50-foot ends by use of large doors and using the south wall of the Graybar Building as the north wall of the 50 feet by 120 feet enclosure.

11. The minutes of a meeting of the Board of Directors of the American Manufacturing Company held on the 15th day of December, 1945, substantially set forth the terms of the oral lease which was later reduced to writing in a written lease dated March 17, 1947, running between Grace H. Cunningham and the American Manufacturing Company. A copy of the lease and the minutes are attached hereto, identified as Exhibits 1-A and 2-B, respectively, and incorporated herein by this reference.

12. Grace H. Cunningham, being the largest stockholder and manager of said American Manufacturing Company, was desirous of permitting the company to expand its business and obtain the then necessary room by changing the craneway into a complete structure.

13. The taxes on Lots 8 to 12, inclusive, including improvements, for the years 1946 to 1950, inclusive, are as follows:

1946—paid in 1947	$218.11
1947—paid in 1948	677.11
1948—paid in 1949	588.46

1949—paid in 1950..... 689.63
1950—paid in 1951..... 620.71

The annual cost of insurance was $66.66; Maintenance, nonsegregable.

14. Each of the deficiency notices in the above proceedings state that the cost of improvements for the year 1946, which was the building in question, was $21,904.33. Included in this amount is $4,734.00, which is the amount of money paid for the joint use of the southerly wall of the Graybar Building as a party wall. Attached hereto, identified as Exhibit 3-C and incorporated herein by this reference is a copy of a Party-Wall Agreement dated March 29, 1946. This document was properly acknowledged and is filed of record with the County auditor of Pierce County as of April 22, 1946, Vol. 817 of deeds, Pages 705 and 706, file number 1407577.

15. There is also included in the figure of $21,-904.33 an item of $2,755.00, the cost of the construction and hard surfacing of a public alley, the alley being the 40-foot alley connecting South 22nd and South 23rd Streets, and is situated between said Block 2103, occupied by the American Manufacturing Company, and said Block 2102. This alley was filled and brought up to grade and blacktopped by the American Manufacturing Company and the Graybar Building owners jointly. The American Manufacturing Company's share of the cost was $2,755.00. This alley has never been vacated and is open to the use of the public and is continuously

used by the public, and constitutes one of the alleys in the street system of the City of Tacoma.

16. This $2,755.00 does not constitute any proper part of the cost of the said building, consequently the $2,755.00 cost of the alley should be deducted from the sum of $21,904.33. The question of whether or not the cost of the party wall under the circumstances of this case should also be deducted from the $21,904.33 is a matter which must be left to the determination of the Court.

17. In the construction of the walls erected by the American Manufacturing Company in the transforming of the craneway into an enclosed building hollow cement tile and large windows were used. This constituted the cheapest type of construction permitted by the Building Code of the City of Tacoma.

18. On January 2, 1952, the American Manufacturing Company released all right, title and interest in and to said improvements to Grace H. Cunningham, taxpayer herein. This release did not change or purport to change the rights of the parties under the party-wall agreement heretofore referred to.

19. On the 2nd day of January, 1952, the petitioners, as husband and wife and as a community, executed a new lease to the American Manufacturing Company covering Lots 8 and 9 and the East 40 feet of Lot 10 in said Block 2102, together with improvements. A copy of this lease is attached

hereto, identified as Exhibit 4-D, and incorporated herein by this reference.

20. Said lots 7 to 12, inclusive, which were originally owned by said Petrich and Hunt, constituted in the main a deep hole or depression and had little usable surface which was up to grade. This hole or depression, which in some places was approximately 30 to 40 feet below grade, had for many many years constituted a dumping ground for rubbish and scrap of various kinds.

21. In accordance with an oral agreement American Manufacturing Company was given permission to utilize so much of said lots as were usable and to fill in as much of said lots as the American Manufacturing Company chose to do. Under this arrrangement the lots were, by 1943 or 1944, filled so as to become usable over their entire area; during this period of time the American Manufacturing Company never paid a dollar of rent nor did it pay any taxes to the original owners.

22. The only specified cash rent as such that has ever been paid, up to January 1, 1952, for the use of any part of these properties was $10.00 a month for a portion of the year 1943, which was prior to Grace H. Cunningham's purchase. This covered Lots 8 to 12, inclusive. Since January 1, 1952, the American Manufacturing Company has paid rent of $10.00 per month, together with taxes, for Lots 8 and 9 and the East 40 feet of Lot 10 of said Block 2102.

23. The following is a statement of the money expended by the American Manufacturing Company prior to January 1, 1946, the date of the lease:

Roofing the craneway and the enclosure of the south wall thereof with hollow tile and glass windows.....	$ 2,800.00
Cost of grading and paving the alley	2,755.00
24. The cost of the party wall was	4,734.00
25. The American Manufacturing Company spent	11,097.00

subsequent to the date of the lease of January 1, 1946, as cost of improvements which pursuant to the lease were to revert to the petitioner, Grace H. Cunningham at the end of the lease period.

26. The assessed valuation, exclusive of improvements, as determined by the County assessor for the various years involved in the lease period was $2,-800.00, and the average rate of taxation during said period was roughly 6.5%. The average annual tax during said period, exclusive of improvements, was $182.00.

27. The following are the sales of the American Manufacturing Company for the years 1946 to 1955, inclusive:

1946	$ 436,615.84
1947	678,094.07
1948	676,358.91

1949	$ 420,875.01
1950	726,439.21
1951	990,667.06
1952	920,255.60
1953	1,171,648.13
1954	974,929.02
1955	1,456,533.06

28. That the improvements placed upon the property by the American Manufacturing Company, which under the terms of the lease are to revert to the taxpayer at the end of the lease period, are improvements attached to the realty.

29. The American Manufacturing Company capitalized the total cost of $21,904.33 on its books and corporation income tax returns and claimed depreciation for one-sixth of that amount as a deduction for income tax purposes during each of the taxable years 1946 to 1951, inclusive.

30. The parties to these proceedings, Eugene F. Cunningham and Grace H. Cunningham, were at all times herein mentioned and now are husband and wife. That during 1946 Lots 8 to 12, inclusive, of said Block 2102, were owned by Grace H. Cunningham as her sole and separate property. Thereafter and prior to January 1, 1952, the above-described property, together with improvements, had by proper instruments of conveyance become the community property of Grace H. Cunningham and Eugene F. Cunningham, her husband. In Docket

No. 55090 the Respondent has determined that the cost of the improvements to the aforesaid real estate made by the lessee subsequent to January 1, 1946, which by the terms of the lease would revert to Grace H. Cunningham at the end of the six-year period, constituted taxable income to Grace H. Cunningham in 1946. In Docket No. 55091 the Respondent has further determined that the cost of the said above-referred-to improvements became taxable income to Eugene F. Cunningham and Grace H. Cunningham in 1952.

/s/ RAYMOND D. OGDEN,
Counsel for Petitioner in Docket No. 55090 and Counsel for Petitioners in Docket No. 55091;

/s/ C. L. STONE,
Counsel for Petitioner in Docket No. 55090 and Counsel for Petitioners in Docket No. 55091.

/s/ JOHN POTTS BARNES, WHP
Chief Counsel, Internal Revenue Service, Counsel for Respondent.

EXHIBIT 1-A

Lease

This Indenture, made this 17th day of March, 1947, between Grace H. Cunningham and American Manufacturing Company, Inc., hereinafter designated as the lessor and the lessee,

Witnesseth:

That the said lessor does by these presents lease and demise unto the said lessee the following described real estate and premises, situate in the City of Tacoma, in the County of Pierce and State of Washington, to wit:

Lots 8, 9, 10, 11 and 12, Block 2102, Tacoma Land Company, Fifth Addition

with the appurtenances, for the term of six years from the 2nd day of January, 1946, to the 2nd day of January, 1952. The consideration for said lease being that the lessee will pay taxes on the above-described property for a period of six years and will transfer, at the end of the period of the lease, all right, title and interest which said lessee has in a building which lessee has constructed and paid for on the above-described property.

And It Is Hereby Agreed that if default shall be made in any of the covenants herein contained, then it shall be lawful for said lessor to re-enter the said premises and remove all persons therefrom, and the said lessee does hereby covenant, promise and agree to carry out the conditions of this lease in the manner hereinbefore specified, and not to let or underlet the whole or any part of said premises, nor assign this lease nor any interest therein without the written consent of said lessor.

And at the expiration of said term, the said lessee will quit and surrender the said premises in

good state and condition as they now are (ordinary wear and damage by the elements or fire excepted).

In Witness Whereof, the said parties have hereunto set their hands and seals the day and year first written.

/s/ GRACE H. CUNNINGHAM,
American Manufacturing
Company, Inc.

By /s/ T. M. GEPFORD,
President.

State of Washington,
County of Pierce—ss.

I, H. E. McLean, Notary Public, in and for the State of Washington, residing at Tacoma, do hereby certify that on this 17th day of March, 1947, personally appeared before me Grace H. Cunningham, to me known to be the individual in and who executed the within instrument and acknowledged that she signed and sealed the same as her free and voluntary act and deed for the uses and purposes herein mentioned.

Given Under My Hand and Official Seal this 17th day of March, 1947.

[Seal] /s/ H. E. McLEAN,
Notary Public in and for the State of Washington, Residing at Tacoma.

State of Washington,
County of Pierce—ss.

On this 17th day of March, 1947, before me personally appeared T. M. Gepford to me known to be the President of the corporation that executed the within and foregoing instrument, and acknowledged said instrument to be the free and voluntary act and deed of said corporation, for the uses and purposes therein mentioned, and on oath stated that he was authorized to execute said instrument and that the seal affixed is the corporate seal of said corporation.

In Witness Whereof I have hereunto set my hand and official seal the day and year first above written.

[Seal] /s/ H. E. McLEAN,
Notary Public in and for the State of Washington,
Residing at Tacoma.

EXHIBIT 2-B

Minutes of Special Meeting of Board of Directors of American Manufacturing Company, Inc.

A special meeting of the Board of Directors of the American Manufacturing Company, Inc., having been called by the President for the 15th day of December, 1945, at the hour of 10 a.m. o'clock at the office of the Corporation at 2119 Pacific Avenue, Tacoma, Washington, and all members of the

Board having signed a Waiver of Notice of time, place and purpose of the meeting, the following business was transacted:

The President announced that, due to the rapidly expanding business of the American Manufacturing Company, Inc., it was necessary to have more building space. That Grace H. Cunningham owned certain real property, namely, Lots 8, 9, 10, 11 and 12, Block 2102, Tacoma Land Company, Fifth Addition, Tacoma, Pierce County, Washington. That said property was situated strategically and would make an ideal building site for said American Manufacturing Company, Inc. The President also announced that said Grace H. Cunningham was desirous of leasing said property to the American Manufacturing Company, Inc., on the following basis:

That the American Manufacturing Company would construct a building on said property at its own expense; would pay all the taxes, and at the end of a six-year period, said lease would be terminated and the building on the property would revert to the owner of the real property, Grace H. Cunningham. That there would be no rent paid for said lease but that the consideration for the lease was the transfer of the building to Grace H. Cunningham at the end of the term of the lease. Therefore, after full discussion having been had, the following resolution was unanimously adopted:

"Be It Resolved, that the proper officers of the American Manufacturing Company, Inc.,

be instructed to prepare the proper instruments to lease from Grace H. Cunningham, Lots 8, 9, 10, 11 and 12, Block 2102, Tacoma Land Company, Fifth Addition, Tacoma, Washington, for a period of six years commencing with the 2nd day of January, 1946. That the terms and conditions of said lease be such that the consideration for said lease would be the transfer of any and all interests that the American Manufacturing Company, Inc., had in the building to be constructed on the premises to be transferred to Grace H. Cunningham. That American Manufacturing Company, Inc., would immediately commence construction of a building on said premises of the approximate value of $25,000.00. That the proper officers of the American Manufacturing Company, Inc., also be instructed to pay the taxes on said property for the term of the lease."

The Secretary was instructed to note in the minutes that inasmuch as Grace H. Cunningham was a party involved in this transaction, she did not vote on the above resolution.

There being no further business to come before the meeting, the meeting was adjourned.

/s/ JACK M. MOE,
Secretary.

Attest:

/s/ T. M. GEPFORD,
President.

(Copy.)

EXHIBIT 3-C

1407577

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Party-Wall Agreement

This Indenture Made this 29th day of March, 1946, by and between Eugene F. Cunningham, hereinafter referred to as First Party, and Grace H. Cunningham and The American Manufacturing Company, Inc., hereinafter referred to as Second Parties,

Witnesseth:

Whereas, the parties hereto are the owners of adjoining pieces of property in Tacoma, Pierce County, Washington,

And Whereas, it is the mutual desire of said parties to make and enter into an agreement to designate a certain wall, dividing their said properties, as a Party Wall.

Now This Indenture Witnesseth, that in consideration of this agreement and of the covenants hereinafter contained, each of the said parties hereby covenants with each of the others, his heirs and assigns in the manner following:

(1) It is mutually agreed between First Party and Second Parties that the South wall of the Graybar Building, which said building is situated on the following described property:

Lots 7, 6, 5, and 4, Block 2102, Tacoma Land Company's Fifth Addition, Tacoma, Pierce County, Washington,

and which said wall is constructed of:

12-in. concrete block wall, 8x12x16-in. blocks, 14 ft. 9 in. high, supported by a 8-in. x 1-ft. 8-in. footing and 12 in. concrete wall 2 ft. high,

shall be from this date hence forward and shall so remain until changed by stipulation of the parties hereto, their heirs, executors, or assigns, a Party Wall, and shall be and become and remain the common property of the parties hereto.

(2) It is further agreed between the First Party and Second Parties hereto that the Party Wall herein described shall be,

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become, and remain a Party Wall with the lines and boundaries as they are now established, and in no other manner.

(3) It is agreed between First Party and Second Parties hereto that this agreement shall include the wall herein described or a replacement thereof, on the lines and boundaries as now established, and that the covenants herein contained shall run with the land, and that the rights, duties, and obligations resting upon the Parties hereto by virtue of the covenants herein contained, shall continue until such time as said parties otherwise agree.

In Witness Whereof, we have placed our hands and seals this 29th day of March, 1946.

/s/ EUGENE F. CUNNINGHAM,

/s/ GRACE H. CUNNINGHAM,

/s/ T. M. GEPFORD,
President, American Mfg. Co.

State of Washington,
County of Pierce—ss.

I, the undersigned, a Notary Public in and for the State of Washington, hereby certify that on this 29th day of March, 1946, personally appeared before me Eugene F. Cunningham and Grace H. Cunningham, to me known to be the individuals described in and who executed the foregoing instrument and acknowledged that they signed and sealed the same as their free and voluntary act and deed for the uses and purposes therein mentioned.

Given Under My Hand and Official Seal the day and year last above written.

[Seal] /s/ M. McELROY,
Notary Public in and for the State of Washington,
Residing at Tacoma.

(Copy.)

EXHIBIT 4-D

Lease

This Indenture, made and entered into this 14th day of January, 1952, by and between Grace H. Cunningham and Eugene Cunningham, Lessors and American Manufacturing Company, Inc., a corporation, organized and existing under and by virtue of the Laws of the State of Washington, as Lessee,

Witnesseth:

That the Lessors do, by these presents, lease and demise unto the Lessee the following described real estate, situated in the City of Tacoma, County of Pierce, State of Washington, more particularly described as follows:

> Lots 8 and 9, and the East 40′ of Lot 10, Block 2102 Tacoma Land Company Fifth Addition to the City of Tacoma,

together with appurtenances thereunto belonging, for a term of ten (10) years from and after the 1 day of January, 1952.

The Lessee agrees to pay as rental the sum of Ten ($10.00) Dollars per month, payable in advance on the first day of each and every month for the term of this lease, and in addition thereto, agrees to pay all taxes of every kind and nature charged against said property, together with any and all other expenses of any kind or character incident to the occupation or maintenance of said premises.

Lessee agrees to keep said premises in as good state of repair as the same now is, natural wear and tear excepted, and upon the expiration of this lease to deliver said premises to the Lessors in as good condition as the same now is, natural wear and tear excepted.

Any additions or repairs or improvements placed upon said building shall, at the expiration of this lease become the property of the Lessors, and shall not by the Lessee be removed from said building upon the expiration of said lease.

Lessee further agrees to keep said building fully insured in an amount entirely satisfactory to said Lessors, and to deliver a copy of said policy of insurance to the Lessors.

In Witness Whereof, the parties hereto have set their hands and seals the 14th day of January, 1952.

/s/ GRACE H. CUNNINGHAM,

/s/ EUGENE F. CUNNINGHAM,
Lessors.

[Seal] AMERICAN MANUFACTURING COMPANY, INC.,

By /s/ T. M. GEPFORD,
President;

By /s/ JACK M. MOE,
Secretary,
Lessee.

State of Washington,
County of Pierce—ss.

I, H. E. McLean, a Notary Public in and for the State of Washington, residing at Tacoma, in the above-named County and State, duly commissioned, sworn and qualified, do hereby certify that on this 14th day of January, A.D., 1952, before me personally appeared Grace H. Cunningham and Eugene Cunningham, to me known to be the individuals described in, and who executed the within instrument as their free and voluntary acts and deeds, for the uses and purposes therein mentioned.

Given Under My Hand and Official Seal This 14th Day of January, 1952.

[Seal] /s/ H. E. McLEAN,
Notary Public in and for the State of Washington,
Residing at Tacoma.

State of Washington,
County of Pierce—ss.

On this 14th day of January, A.D., 1952, before me personally appeared T. M. Gepford and Jack M. Moe, to me known to be the President and Secretary, respectively, of the corporation that executed the within instrument and acknowledged the said instrument to be the free and voluntary act and deed of said corporation, for the uses and purposes therein mentioned, and on oath stated that they were authorized to execute the said instrument

and that the seal affixed is the corporate seal of said corporation.

In Witness Whereof, I have hereunto set my hand and affixed my official seal the day and year first above written.

[Seal] /s/ H. E. McLEAN,
Notary Public in and for the State of Washington, Residing at Tacoma.

Filed at hearing May 17, 1956.

The Tax Court of the United States
Docket No. 55090

GRACE H. CUNNINGHAM,
Petitioner,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No. 55091

EUGENE F. CUNNINGHAM and GRACE H. CUNNINGHAM,
Petitioner,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Thursday, May 17, 1956

The hearing in the above-entitled matter was convened at 9:30 o'clock a.m., before

The Honorable Craig S. Atkins, Presiding.

Appearances:

RAYMOND D. OGDEN, ESQ.,
On Behalf of the Petitioner.

JOHN H. WELCH, ESQ.,
On Behalf of the Respondent.

PROCEEDINGS

The Court: Are you ready to proceed, gentlemen?

The Clerk: Docket 55090 and 55091, Grace H. Cunningham and Eugene F. Cunningham. Will counsel state their appearances?

Mr. Welch: John H. Welch, appearing for the respondent, your Honor.

Mr. Ogden: Raymond D. Ogden, appearing for the petitioner.

The Court: Do you care to make an opening statement, Mr. Ogden?

Mr. Ogden: Yes.

If it please the Court, I take it the necessity for an opening statement is because of the reason that we have stipulated most of the facts. There are certain facts which we couldn't agree on in the stipulation, and the evidence will be directed toward those matters. But it did seem to me that before we got into it that something ought to be said. It would be a funny-sounding thing to the Court sitting up there and not know what it is all about.

The case, we have two cases which are combined together and they involve identically the same state of facts. The matter arose in this wise: The pe-

titioner, the taxpayer, Mrs. Cunningham, owned certain lots over in the City of Tacoma, five in number, and on those lots certain improvements [3*] were placed and those improvements were at first under an oral lease and then a year and two months later a written lease was entered into. And the provision of the lease was that there was to be no rent but the building improvements, whatever they were, would at the end of the six-year period revert to the owner. The agent elected to hold that those improvements were made in lieu of rent and, therefore, were subject to be listed as gross income subject to tax.

The Court: In which year?

Mr. Ogden: In 1946, which was the year that the improvements were put in.

The Court: Rather than the end of the lease year?

Mr. Ogden: Yes. Now, the second case, after this got down to the Commission, he issued his 90-day letter saying that this should be considered as gross income in 1946, the year that the improvement was made, then along later he comes through with a second matter, second letter in which he holds, well, they started all over again and held that it was income at the end of the lease when the reversion took place. So we have one case that is income at the time the improvements were placed upon the property, and one that was income when it reverted.

The Court: And both involved the same property?

*Page numbering appearing at top of page of original Reporter's Transcript of Record.

Mr. Ogden: Absolutely the same identical thing. The facts now that are somewhat in controversy, not [4] in controversy but the department didn't want to feel that they wanted to stipulate them, is the matter to which I first direct your Honor's attenion. The American Manufacturing Company is a corporation over in Tacoma and they are engaged in the manufacture of heavy equipment, heavy steel equipment, machinery. That business was started in 1928 by Mrs. Cunningham, the taxpayer, sitting here at the table. Later in 1936 it was incorporated under the name of the American Manufacturing Company. Mrs. Cunningham is the owner and controls the capital stock of that corporation, and has been its manager ever since it started, spending her time six days a week now since 1928 in the business. Not only has she been its manager, but she has also been its financier, all obligations of the corporation have been endorsed and guaranteed by her to the banks, running into $175,000, $200,000.

Her husband at the time in 1946 when their nine properties were divided, she had her separate property and he had his separate property. Therefore, the first tax matter is charged to her as an individual in '46 because then she was the owner individually. Prior to 1952, the termination of the six-year lease, they again combined their separate properties back into community property so that the second 90-day letter was addressed to Grace Cunningham and Eugene Cunningham, her husband.

The Court: May I interrupt to ask one thing.

How do [5] you go about combining your separate properties to make it community property?

Mr. Ogden: In the State of Washington——

The Court (Interrupting): Yes?

Mr. Ogden (Continuing): ——that can be done by deed and written declaration and a transfer. You can take them out of community property with a declaration, and the deed is made accordingly so that they are separate property. If the presumption of this day is after marriage that all property acquired thereafter is community property and again separate property, if commingled after marriage can by virtue of such commingling become community property. Does that answer your question?

The Court: Yes. Thank you.

Mr. Ogden: In 1946 the American Manufacturing Company was in need of more space. They have a plant and right across the alley, a 40-foot alley lay these vacant lots. These vacant lots as stated in the stipulation were of such physical character that they were of little use and had been of little use for many, many years, in fact they were used for a dumping ground by the American Manufacturing Company and its predecessor used those lots for outdoor storage without paying any rent, taxes or otherwise, to the owners. In 1945 the American Manufacturing Company through an agreement with the owners arranged to place upon Lot 9 a craneway and I will hand to the Court a [6] photograph and I will ask to have that later admitted in evidence. That is a photograph of the craneway.

These lots are 25 feet wide and 120 feet long. This craneway that you see runs the full length of the 120 feet. In 1945 this was erected by the American Manufacturing Company on the property, the property at that time belonging to the original owners, their names are set forth in the stipulation. When this craneway was going to be built on the property, the original owners said if you are going to put the craneway on it you are going to have to pay some rent because it is going to increase the taxes, and when you get through you have to take it off.

In 1946 the American Manufacturing Company needed still more space and the evidence will show that they had no money with which to buy this property, being at that time indebted to the extent of around $140,000 to Cunningham Steel Company. Mrs. Cunningham bought these lots and she bought them for $8,000, there were then six lots, one of them was sold to the people who built the Graybar Building which lies just to the north. So you had, then, this property with a craneway on it when Mrs. Cunningham bought it. She then, after they bought it in October of 1946—now I say she because she now is still manager, owner and the financier of the American Manufacturing Company. She then had them, or the American Manufacturing Company did then roof over this craneway, put a roof on it and along the wall that you see facing you, which [7] was the south wall they enclosed the whole length of the south wall with cement tile and large windows, 17 by 18 steel windows that we use in manufacturing plants. That was enclosed on the south side.

Under the stipulation the cost of that whole matter was estimated to be $2,500 to $2,800.

At the end of 1945 American Manufacturing Company still needed more room, so it was then determined that they would enter into a lease agreement with Mrs. Cunningham whereby they would proceed, now, with the craneway that you see boxed in by a wall on the south, from which our storms come, so it was open space to work in. They then proceeded to build a roof over Lot 8 which lies just directly north of the picture you are seeing. That also is 25 feet wide and 120 feet long. Beyond that lay the Graybar Building, a one-story building which was built by Mr. Cunningham, private property, and Mrs. Cunningham had no connection or no investment in the Graybar Building, but the Graybar Building constituted the north wall of this improvement that they were going to put in. In other words, they were going to bridge from the present craneway you see over to the wall of the Graybar Building, put a roof on it and they would then have a piece of ground 120 feet long by 50 feet wide, being the two lots. They were then to close in the ends of those lots and thus make an area with cement floors of 50 feet wide and approximately 120 feet long. That was the improvement which was put in by the American Manufacturing Company [9] after January 1, 1946, at the date of the oral lease. In the stipulation it is provided that the cost of that improvement, namely roofing over, closing in the ends, laying the cement floor, was around $11,-094. That was the extent of the money invested by

the American Manufacturing Company after the first of January, 1946, which under the terms of the lease would revert to Mrs. Cunningham January 1, 1952. And in the Commissioner's 90-day letter he said that that improvement put in by the American Manufacturing Company after January 1, 1946, constituted—which would revert to her at the end of the period, constituted rent. Now, that is one of the things that we couldn't agree on, that statement I just made. The evidence will support that statement.

The second question that we have to devote some attention to in the evidence is whether or not at the time of the making of this oral lease which a year and two months later was reduced to writing, what was the intent of the parties. Now, I have no quarrel at all with the department for not wanting to put in the stipulation that the intent of the parties was so and so, and that was to be a matter of evidence. The evidence will show that it was the intent of American Manufacturing Company and of the taxpayer that there should be no rent. It is a peculiar situation, if your Honor please, because Grace Cunningham, manager, largest stockholder and controller of the American Manufacturing Company, the president of which was her brother who deals with herself as a taxpayer relative to these lots that she bought for the use and benefit of American Manufacturing Company, and that is your situation exactly.

Now, the third matter is the question of what

rent—for the sake of argument, granted for the sake of argument that it could be held that this improvement was a liquidation of rent and, therefore, getting around the statute which was passed in 1942, still, it is only a liquidation of such rental as is appropriate to the property involved. Therefore, I want to prove, we want to prove what was the fair rental value of those five vacant lots in 1946. That rental value, whatever that rental value may be is the total amount, according to the theory of the taxpayer that could be allocated to gross income over the period.

The next point, the Commissioner in determining the market value of the improvement, took a figure of $21,000 and in that $21,000 he then in 1946 deducted depreciation of two and a half per cent, or a four year life, and then computed what the value of that sum so derived multiplied by four per cent which gave him a factor of 78 or something, which gave him what he said was a fair market value of the improvement. Now, we want to prove, and will prove, and the stipulation couldn't be entered into with respect thereto as to what was the true market value of this improvement which was put upon the property subsequent to January 1, 1946. That, then, is a [10] question that involves the amount of the rent.

Now comes the third and last, and that is what depreciation, if any, should be permitted in the type of improvement that was made. To clear the atmosphere just a little more, but this is in the stipulation, I don't want—there won't be any evidence

introduced in regard thereto, but to make the statement intelligibly, the tax agent took from the books of the American Manufacturing Company an item of $21,000 and some odd dollars which was on their books fixed as the cost to American Manufacturing Company of the improvement placed upon these lots. The stipulation shows that in that 21,000 dollars was the grading and paving of a 40-foot alley which lay between the main plant of the American Manufacturing Company and these lots. That ran over $3,000, some odd figure. Then that, of course, is an open alley in the City of Tacoma and the stipulation says that should be deducted from the $21,000 because that is no part of the improvement.

The second question is when the Graybar Building was built, that a party-wall agreement was entered into in writing in March of '46 in which Eugene Cunningham sold to the American Manufacturing Company and to Grace Cunningham a one-half interest in that wall for the sum of $4,000 and some odd dollars. It is in the stipulation. Now, we couldn't agree that the stipulation should say that that cost of the party wall should be deducted from the $21,000 because it was no part of the [11] improvement and in the stipulation it is recited that the determination of where that shall be allocated shall be left up to the Tax Court. The position of the taxpayer, of course, being that the party-wall agreement speaks for itself, they say it is an agreement running with the land and it is in

the form and shape of the properly executed and properly filed agreement.

The third item that is in this $21,000, the first being now the party wall, the second being the alley, the third item is the cost of these improvements in the photograph which you see which were put on the property prior to the making of the lease so that the stipulation provides that the cost of the improvements that was put on the property subsequent to January 1 is $11,000 and some odd dollars which is not, of course, the $21,000 that was used by the agent when he first fixed the price.

I think that covers the matter.

The Court: Very well. Mr. Welch, do you have a statement?

Mr. Welch: Yes, your Honor.

If the Court please, I think your Honor realizes that the respondent has taken two positions in this proceeding. At the present time I don't regard either position as an alternative, they are both Primary positions, and of course we don't expect to prevail upon both because the same transaction is involved. We expect that the value of the improvement placed [12] on this land will constitute income either in 1946 or in 1952.

The Court: In that connection will you take a position on a brief as to one or the other or perhaps you don't know at this time?

Mr. Welch: I expect to do this, your Honor, on brief argue one of the years as a primary position and then the other as an alternative, but at the

present time I am not prepared to state which is the primary one.

The Court: If the year 1952 is the year in which it might be taxable, I presume the value would perhaps be less than at the time of construction or not? Is that what Mr. Ogden was talking about, about the depreciation on it?

Mr. Welch: The way it is set forth in the deficiency letters, the deficiency for 1952 is larger because the respondent there has simply taken the cost and applied what he determined to be a proper rate of depreciation to arrive at the 1952 value, but he has further reduced the 1952 value by a factor in order to arrive at what would be the value of the future right in six years, it was in 1946 so actually it would have to be a smaller amount than 1946 because of that factor. We agree in the stipulation that these cases may be consolidated, your Honor, and we expect to offer the stipulation right at the conclusion of my statement and the stipulation of facts covers, of course, the majority of the facts that the Court will be expected to consider in arriving at his decision. The [13] lease and the corporate minutes are identified in the stipulation and the terms thereof are set forth in their entirety. From our standpoint, no further explanation of the provisions of those documents is necessary. Petitioner expects to offer some further evidence in that respect, but from our standpoint we feel the documents cover the situation adequately. The Court will have to decide the question of the party wall in this proceeding. We have agreed on the cost, the

American Manufacturing Company's share of the cost of the party wall. We have stipulated as to the agreement itself and the question, of course, arises as to whether that is actually part of this real estate and, therefore, a part of the reversion which occurred in 1952. Setting forth in our deficiency letters the amount of income to be included, we have used a depreciation rate of two and a half per cent on a factory building which is about average in accordance with Bulletin "F" and other publications that have appeared with respect to proper rates of depreciation. And respondent has relied on the cost as shown by the taxpayer's records, however, there are some adjustments in the stipulation because we later discovered that part of that cost was attributable to the improvement of an alley which was not on the land. It was a public alley and therefore didn't enter the controversy here. The reason, I don't think Mr. Ogden covered it, that there are two petitioners in the second docket that is involved here, is that in 1946 [14] a separate income tax return was filed by Mrs. Cunningham, in 1952 a joint return was filed by Mr. and Mrs. Cunningham, and that, of course, explains, in addition explains the reason why Mr. Cunningham is a party to this proceeding.

In connection with the problem of rental, from respondent's standpoint the fair rental of vacant land in Tacoma really isn't a problem. Mr. Ogden indicated that he expected to establish what was the fair rental of this property, but again from our

standpoint we feel that it is immaterial to this proceeding.

The Court: In other words, you feel that in this case you have evidence of what it was worth, you have evidence about the improvement that was made and to revert to the owner, is that true?

Mr. Welch: That is right.

The Court: I see.

Mr. Welch: I have no further statement at this time, your Honor, except that I would jointly with Mr. Ogden offer the stipulation of facts and indicate to the Court that there are four exhibts attached, that is, 1-A through 4-D. They are identified in the stipulation and physically attached. I would like to offer them as a part of the stipulation.

The Court: The stipulation will be received in evidence.

(Respondent's Exhibits 1-A, 2-B, 3-C and 4-D were marked for identification and received in evidence.) [15]

Mr. Welch: Could I move at this time, your Honor, that these cases be consolidated for the purposes of the hearing?

Mr. Ogden: That is agreeable with us.

The Court: They will be consolidated for hearing.

I have no questions at this time. Do you care to go ahead at this time with your proof, Mr. Ogden?

EUGENE F. CUNNINGHAM

was called as a witness by and on behalf of the petitioner, and, having been first duly sworn, was examined and testified as follows:

The Clerk: Will you state your name and address, Mr. Witness?

The Witness: Eugene F. Cunningham, 2026 Louisa Street, Seattle 2, Washington.

Direct Examination

By Mr. Ogden:

Q. Mr. Cunningham, you are the husband of Grace Cunningham? A. That is right.

Q. And you are the Eugene Cunningham who together with Mrs. Cunningham made the joint return in 1952? A. Yes. sir.

Q. In 1946, what was your connection, if anything, with American Manufacturing Company?

A. I think I was vice-president of the company at that [16] time and had not been actively interested in it at that moment, up until that time.

Q. Were you on the board of directors at that time? A. That is right, I believe so.

Q. Were you present at the time in 1946—no, in 1945 when a meeting was held of the board of directors of the American Manufacturnig Company in which the matter of leasing lots 8 to 12, inclusive, was taken up? A. I believe I was.

Q. Do you know what use, if any, the American Manufacturing Company had made of these lots prior to 1946? A. Yes, I do.

(Testimony of Eugene F. Cunningham.)

Q. State to the Court what that was.

A. They had erected a temporary craneway, more or less temporary craneway on the building, they had also previously erected an annealing oven which I believe was torn down very shortly after these additional improvements were put up. The purpose of it was for war work that they had been doing for Webster Pringle Company.

Q. Prior to the time the annealing oven was put on there had the American Manufacturing Company been using those lots?

A. Yes, they had, for a number of years for storage and various other purposes.

Q. Had any rent been paid to the owners?

A. Not to my knowledge up until the time they put the [17] craneway on.

Q. At the time the craneway was put on the property by the American Manufacturing Company, was there a rent paid then?

A. Yes, the sum of $10.00 a month.

Q. Ten dollars a month? A. Yes.

Q. To the original owners?

A. Yes, a Mr. Petrich, I believe it is.

Q. The reason I am not going into that more in detail, the original owners are set forth fully in the stipulation.

In what line of business was the American Manufacturing Company engaged in?

A. They were engaged in the manufacture of sawmill and plywood items, machinery, during the war they were manufacturing components for ships

(Testimony of Eugene F. Cunningham.)

for the Webster Pringle Company and for various other concerns.

Q. State to the Court whether or not there was any need or intention on the part of American Manufacturing Company for additional space?

A. Yes, they were very pressed for space, they had expanded to the extent of the craneway and an annealing oven out there, and they were still in dire need of improvements in the alley and for handling the material in and out, as well as additional working space, and they needed steel cutting equipment, etc., a place to put it. [18]

Q. Do you know whether or not the American Manufacturing Company in 1946 was in a financial position to buy lots 8 to 12, inclusive?

A. No, they were not.

Mr. Welch: Objection, your Honor.

The Court: What is the objection?

Mr. Ogden: The reason for asking the question is to show that at the time the necessity for expansion occurred that the reason the American Manufacturing Company did not buy these lots was because they were not in a financial position to buy them, that Mrs. Cunningham bought them for the use and benefit of the American Manufacturing Company and for no other purpose whatsoever.

The Court: Your objection, Mr. Welch?

Mr. Welch: My objection, your Honor, is that the financial condition of American Manufacturing Company is not a relevant matter in this proceeding. It is stipulated that Mrs. Cunningham bought

(Testimony of Eugene F. Cunningham.)

the lots and I don't feel that this Court should inquire into whether or not someone else might have bought the lots under the circumstances. I don't think it is material to the controversy.

Mr. Ogden: The other reason, if your Honor please, is that the cases involving this question of whether or not buildings placed upon leased property by the lessee and reverting after a period of time to the lessor when, how and where [19] shall it, if ever, be called gross income subjecto to tax. This question perplexed the courts of this nation for over forty years, even before the question of legal rights, even before the income tax came in in 1914, and after that the Supreme Court has held and the Circuit Court of Appeals many times have held that to determine whether or not it was the intent of the parties that this improvement placed upon the leased premises was to be considered as rent or at least a portion of it as rent, or part of it was rent, was to be determined one, from the instruments, two, from the expression of the parties as to their intent at the time, and the third, the facts surrounding the transaction, all of which were to be considered by the court in determining whether or not it ever was the intent of the parties that the structure should have been at least in part, if not wholly for rent. Now, that is the reason I am asking to have this evidence introduced to show that it was the intent, what the intent of the parties was at the time the property was purchased, then

(Testimony of Eugene F. Cunningham.)

follow it with what they did with the property, much of which is in the stipulation.

The Court: This was a written lease, was it?

Mr. Ogden: The lease was an oral lease to start with in 1946, was not reduced to writing until March of 1947.

The Court: We do have a copy of that in the stipulation?

Mr. Ogden: That is right. And you have a copy in [20] there of the minutes of the American Manufacturing Company in December of 1945 where the officers, proper officers, were directed to enter into these negotiations.

The Court: Well, the Court is disposed to allow the evidence in for whatever it may be worth. Now, I am not admitting anything to vary the terms of this lease, it may be to some extent an explanation of the written lease, but I will allow it in for whatever it may be worth.

I overrule the objection, Mr. Welch.

Q. (By Mr. Ogden): Will you answer the question?

(Question read.)

A. I don't think they were, they owed the Cunningham Steel Foundry, which was my organization in Seattle, some $25,000 and a substantial bank loan in addition. I don't feel that they were in a position to then buy them.

Q. Do you know whether or not there was ever any intent upon the part of the American Manu-

(Testimony of Eugene F. Cunningham.)

facturing Company at the time this agreement was entered into relative to the improvements that were put on subsequent to January 1, 1946, as to whether those improvements were or were not to be considered in part or in whole as rent?

A. No, they weren't.

The Court: Let the Court interrupt. You speak of the intent of a corporation—— [21]

Mr. Ogden (Interrupting): He was vice-president and director and was at the meeting.

The Court: There was a meeting?

Mr. Ogden: Yes, and the minutes are attached to the stipulation.

The Court: I would like to see the minutes.

Mr. Ogden: They are attached to the stipulation.

Mr. Welch: It is Exhibit 2-B, your Honor.

The Court: Mr. Ogden, the reason I interrupted at this point is for the purpose of saying this, that it is going to be up to the Court to determine whether this was rent or not and we have here the minutes and I presume here we have also the terms of the lease itself.

Mr. Ogden: The lease that was made a year and two months later.

The Court: I think we are going to be governed pretty much by the terms of these instruments.

Mr. Ogden: That is true.

The Court: Now, the minutes state that there would be no rent paid for said lease but that the consideration for the lease was the transfer of the

(Testimony of Eugene F. Cunningham.)

building to Grace H. Cunningham at the end of the term of the lease.

Mr. Ogden: That is right.

The Court: Well, that comes down to a legal question when it says there will be no rent and in the next breath says [22] the consideration for the lease will be the building.

Mr. Ogden: And the payment of taxes.

The Court: It seems to me that maybe you are asking the witness to answer the question that we are called upon to decide, upon the basis of all the evidence here.

Mr. Ogden: I think, if your Honor please, that the question of what is meant by the term consideration is a question of law that will have to be thrashed out.

The Court: I think so.

Mr. Ogden: Of course the Commissioner of Internal Revenue has to define rent and he defined it very fully and completely in an "I.T." in which he says—that will be set forth in our briefs and I don't know if we want to argue that question now—he says rents are specifically a charge made in definite amount of money and paid for a piece of property and must be definite amount and definite substance, and in the Black case they said the same thing. Now, the use of the term "consideration" in there, you will find that in hundreds of leases calls a ground rental where buildings are placed upon the property in truth and in fact the placing of the building upon the property is one of the considera-

(Testimony of Eugene F. Cunningham.)

tions for the entering into of one of those ground leases. The ground rental the lessee gets, the lessor gets, is taxes he gets paid, and if as of the day of reversion he gets the building, that also, all of that is a consideration for the entering into and the use of the [23] term consideration is one that will be set forth fully in the decisions on it in our briefs.

The Court: Very well. I will allow the witness to go ahead on this line, but I just wanted to warn you that I think he is getting very close to stating the conclusion on what the Court itself is going to have to decide and it may not be worth too much in the determination of the case. On the other hand it may be, I am not prejudging that matter of it.

Mr. Ogden: I understand.

(Last question read.)

A. They were not considered as rent.

Mr. Welch: I think that question can be answered yes or no.

Q. (By Mr. Ogden): Can you make a yes or no answer? A. All right, no.

The Court: The other answer will be stricken and this last answer will stand.

The Witness: It is rather a complicated question and I am not too sure that I understand it.

The Court: Off the record.

(Discussion off the record.)

The Court: On the record.

The last question will be stricken. [24]

(Testimony of Eugene F. Cunningham.)

Q. (By Mr. Ogden): Was there at the time of the entering into of this contract in the last week in December of '45 authorizing the lease to be made between American Manufacturing Company and Grace Cunningham covering the lots in question, was there any discussion as to whether or not the improvement that was to be placed upon the property was or was not rent?

A. There was no discussion.

Q. Will you state to the Court the disposition the American Manufacturing Company made of the cost of the improvements on their books, how was it entered on their books.

A. It was capitalized and depreciated.

Mr. Welch: I will have to object, your Honor. I think that has been stipulated to and of course that would be the first basis of my objection, and of course the books would be the best evidence of that.

Mr. Ogden: It is provided in the stipulation that the amount of money was capitalized.

The Court: Strike the answer and the question, then, if it is already stipulated.

Mr. Ogden: Yes.

The Court: Very well.

Q. (By Mr. Ogden): Mr. Cunningham, will you explain to the Court what was the nature and extent of the improvements placed upon Lot 9 [25] being one of the five lots by American Manufacturing after January 1, 1946?

A. Are we speaking of the lot next to the Graybar Company, Lot 9?

(Testimony of Eugene F. Cunningham.)

Q. Eight is the one next to Graybar and nine is the one on which the craneway was built first.

A. There was practically no improvements made to 9 which was the existing craneway, lot 8 was improved, the one next to the Graybar Building.

Q. By what, what did they physically do to it?

A. They put a roof over the top of it, they put ends in the improvement that had been on there as well as the improvement that they were then putting on, a roof and floors and the two ends for enclosures.

Q. Those ends that were enclosed——

A. (Interrupting): ——There was also a craneway, if I may amplify it, a craneway was added to this additional 25 foot lot.

Q. So you had a craneway then on lot 8 which was adjoining the Graybar Building?

A. Right.

Q. And a craneway on lot 9 which had been put in prior to January 1, 1946?

A. Of very similar character, that is right.

Q. The ends of the structure now enclosed, what was the [26] improvements there, was that walls or doors?

A. They were large doors, large doors on each lot about 25-foot doors, I believe there were two doors opening in opposite directions on each one of the lots, on each end of the building, the whole end of the building opened in other words. They were merely doors with a column between.

Q. With respect to the party wall—strike that. If your Honor please, that is in the stipulation.

(Testimony of Eugene F. Cunningham.)

Mr. Cunningham, what was, if you know, the market value of the improvements placed on this property, these lots subsequent to January 1, 1946, by the American Manufacturing Company?

Mr. Welch: I object, your Honor.

Q. (By Mr. Ogden): What was the fair market value of these improvements?

The Court: At what time?

Q. (By Mr. Ogden): Subsequent to January 1, 1946, when they were made.

The Court: When they were completed?

Mr. Ogden: When they were completed, they were completed sometime in the first three or four months of '46.

The Court: Now, there is an objection.

Mr. Welch: He has asked for an opinion now, your Honor, from this witness, and I see no foundation whatever that has been set forth of this witness being qualified in any respect [27] to give an opinion as to the fair market value of the property.

Mr. Ogden: I will strike the question and qualify him.

The Court: Very well.

Q. (By Mr. Ogden): Mr. Cunningham, what is your business? A. Well——

Q. (Interrupting): ——Are you an engineer?

A. Yes, sir, and I have had a great deal of experience in the liquidation of machinery and equipment, buildings, etc., over the years.

Q. At one time you were engaged as a specialist

(Testimony of Eugene F. Cunningham.)

in that business, were you not? A. Right.

Q. For a number of years?

A. Yes, sir. Particularly in the used machinery business.

Q. From your experience not only as an engineer but your experience gained through conducting a private business which had to do with machinery and liquidation of plants, did you acquire knowledge or experience which would qualify you in forming a judgment as to what was the fair market value of these improvements placed on these lots by the American Manufacturing Company after January 1, 1946?

A. I feel that I have.

Q. What, then, in your opinion was the fair market value [28] of these improvements when they were completed by the American Manufacturing Company after January 1, 1946?

A. I would say that it would be at most a few hundred dollars, something less than five hundred dollars more than the cost of removing them, if they had any value.

Q. Why do you reach that conclusion?

A. After all there was nothing to salvage except lumber and heavy timbers which had already been sawed to various shapes and they had little, if any, value at that time after they were taken down. You would have to sell it at a very nominal price and labor was expensive.

Q. What was the normal life of the improvements placed upon this property by the American

(Testimony of Eugene F. Cunningham.)

Manufacturing Company after January 1, 1946?

A. I think that is a very hard question to answer. Probably, I think, obsolescence is the thing that will eventually write them off. I think that the period of the lease determined the value to the American Manufacturing Company or the length of life to the American Manufacturing Company.

Q. State to the Court whether or not the American Manufacturing Company depreciated the cost of these improvements over the period of the lease? A. They did.

Q. Were their tax returns based on such depreciation? A. That is right. [29]

Mr. Welch: I think that is covered in the stipulation of facts and I object.

Mr. Ogden: I think that is all. You may inquire.

Cross-Examination

By Mr. Welch:

Q. Mr. Cunningham, you have stated that you were a director of the American Manufacturing Company? A. That is right.

Q. And when did you take such office, if you recall?

A. I can't remember at the present time. It was quite a number of years ago, even prior to that. I was a director in the American Manufacturing Company, I believe, from its inception.

Q. You were present at the meeting of December 15, 1945? A. Yes, I was.

(Testimony of Eugene F. Cunningham.)

Q. Which has been referred to? A. Yes.

Q. You stated, did you not, at that time that the real estate, that is lots 8, 9 in Block 2102 of the City of Tacoma had the craneway, the temporary craneway?

A. That is right, it did at that time.

Q. Now, at that time you owned the so-called Graybar Building which was adjoining?

A. At that time the Graybar Building was under construction. It was not occupied until May of '46, I believe, officially. [30]

Q. Then the party wall that has been referred to was completed when?

A. Early in '46, I think, between the latter part of '45 and '46. I believe we commenced operations around November in '45 and just what the status of construction was at that time I couldn't say, but I think it was nearing completion anyway.

Q. Now, the American Manufacturing Company's building was a higher building, was it not, than the Graybar Building?

A. That is right, considerably higher.

Q. So this wall had to be extended several feet, did it not? A. That is right.

Q. And if you recall, when was that work done?

A. I don't think I could tell you exactly when, I wasn't on the job all the time, that is, to try to pin it down a few days one way or the other, whether it was in '45 or '46, I don't think I could do so.

(Testimony of Eugene F. Cunningham.)

Q. Would you say it was done after this director's meeting that has been referred to?

A. Right, or about that time anyway.

Q. Now, you stated that the American Manufacturing Company's building was built primarily of hollow tile construction, is that right?

A. No, I don't make such a statement. [31]

Q. That is, of concrete blocks?

A. I didn't make such a statement.

Q. I will withdraw that question.

What was the type of construction used on the American Manufacturing Company's property?

A. So far as the roof and supporting members are concerned, you call it mill construction, simply beams across the top and covered by 2 by 6 tongue and groove material and a roof on top of it, that was the roof construction. The supporting structures were columns of wood both supporting the craneway as well as the building. Square timbers, in other words.

Q. What would be your statement as to the present condition today of this building?

A. I would say that as far as condition is concerned, it is in very fair condition.

Q. Could you estimate the future useful life of that building today?

Mr. Ogden: If you Honor please, I think we are getting a little, I am not criticizing the form of the question, but the matter at issue is the improvements placed upon the property subsequent to the first day of January, 1946. Now, that was not a

(Testimony of Eugene F. Cunningham.)

building, that was an improvement consisting of a roof, cement floors, and enclosed ends which doesn't of itself constitute a building. It became when finished a part of [32] this other structure that had been put on prior to January 1, 1946, the picture of which you have. So I think it cannot be termed as a building, it is an improvement and was so defined by the Commissioner and is the matter at issue.

The Court: Well, I take it that Mr. Welch is trying to determine the depreciation rate on it, are you, for the purposes of evaluation?

Mr. Welch: Evaluation and also to cross-examine the witness who made a statement with respect to obsolescence on direct examination.

The Court: Very well. I will have to allow some latitude in cross-examination.

Mr. Ogden: All right.

Mr. Welch: Will you read the question?

(Last question read.)

A. It is a difficult question. The useful life to the American Manufacturing Company undoubtedly would be twenty years, to anyone else, if they were to discontinue the use of it, it might have little or no value because of the character of the building. It is a very high building, special craneways in it. That is a difficult thing to estimate on a separate depreciation basis.

Q. (By Mr. Welch): Well, would you say that forty years from the date it was completed would be an optimistic estimate as to its life? [33]

(Testimony of Eugene F. Cunningham.)

A. I would say it would be very definitely optimistic.

Q. What would be your statement?

A. I think twenty years would be much more in order because of the obsolescence factor.

Q. That would be twenty years from the present date?

A. No, from the original erection date.

Q. Mr. Cunningham, you are not a real estate man, are you? A. No.

Q. That is, your experience as to values comes from a liquidation of machinery primarily, you say?

A. Yes, and experience in business in general over a period of some forty years.

Q. Could you state some or give an example rather, of a liquidation that you were personally involved in prior to 1946?

A. Cunningham Steel Foundry.

Q. Cunningham Steel Foundry? A. Yes.

Q. That was a business located where?

A. Steel foundry located 4200 West Marginal Way, in Seattle. It employed about 200 men during the war.

Q. Did that company own the real estate, building? A. Yes, sir.

Q. When was that liquidated? [34]

A. 1945 and '46, latter part of '45 and '46.

Q. At that time you were liquidating, or rather selling used machinery primarily?

A. I had previously been connected with the

(Testimony of Eugene F. Cunningham.)

Cascade Machinery here and had organized the company way back in 1918, and the Cascade was an outgrowth of the original companies, they were engaged at all times in the handling of machinery and liquidation of one kind and another.

Q. So you are familiar with salvage values?

A. I think so. We had a great deal of timber available at the Cunningham Steel Foundry in the properties that were not actually being closed, and I had endeavored to sell some of the material from time to time. I knew its value. It was generally the same type of construction as this. In fact, I did sell some of it.

Q. Then in stating your opinion you have referred to removal costs?

A. That is right. They have to be considered.

Q. You haven't attempted to give an opinion as to the value of these improvements as they exist, fixed and attached to the real estate?

A. No, I have not.

Mr. Welch: I have no further questions at this time, your Honor. [35]

Redirect Examination

By Mr. Ogden:

Q. Have you, Mr. Cunningham, any idea of the value of these improvements as they exist and placed there since 1946?

The Court: At what time?

Mr. Ogden: Well, counsel has been asking him at any time.

(Testimony of Eugene F. Cunningham.)

Q. (By Mr. Ogden): We will say now, what is the value of them today?

A. Today is exactly the same as it was in '46 as to market value on them. If you were to remove them they would have only salvage value and it would ve very, very nominal.

Mr. Ogden: Now, if your Honor please, I will bring it into the second assessment by the Commissioner. I know he will ask him in 1952, the termination of the lease, to make the date definite, because that is the date of reversion on which the second letter was based.

Q. (By Mr. Ogden): Does that answer hold to January 31, 1952? A. Yes, sir, it does.

Mr. Ogden: That is all.

Recross-Examination

By Mr. Welch:

Q. Mr. Cunningham, do you know approximately the cost of these improvements that were made in 1946?

A. Yes, it was some $11,000 or approximately that. [36]

Mr. Welch: No further questions.

Mr. Ogden: That is all.

The Court: I would like to ask the witness a question.

I believe, Mr. Cunningham, you said that at the time of construction and in 1952 and now the value of these improvements would be about the same if they were removed?

(Testimony of Eugene F. Cunningham.)

The Witness: That is right.

The Court: Did I understand you to say it would be, the value would be, just a few hundred dollars more than the cost of removal?

The Witness: That is right, the salvage value would be very nominal. It is difficult to say how much but I wager anything they wouldn't bring $500.00.

The Court: Now, you have not expressed an opinion as to whether they were worth something more than that at any of these dates as the existing buildings on these lots?

The Witness: That is right.

The Court: Perhaps you would not care to express an opinion on the value of that, or are not qualified to do so?

The Witness: It would be a difficult question to answer as to what the value is, it would depend upon who to.

The Court: I have no further questions.

Mr. Ogden: This question now is following the questions that the Court asked you, the nature of the improvements [37] that were placed on the premises by the American Manufacturing Company after January 1, 1946, are they of such nature or character that they would be valuable to anyone occupying that property other than the American Manufacturing Company?

The Witness: That is another difficult question. It would just depend on whether it was a machine shop and manufacturer of light character came

(Testimony of Eugene F. Cunningham.)

along. If they did, they would naturally be of considerable value, otherwise they wouldn't.

Mr. Ogden: Do I understand you to say what value it would have to be a special value for special use?

The Witness: Well, let me put it this way. A roof always has some value, but the style and type of building is only valuable to one who is dealing in steel or heavy machinery and equipment of that nature and kind, because it is extremely high, the floors are low, you can't back a truck up, you must unload stuff off the truck. Now the Graybar Building is right alongside and is of truck height, low in ceiling, it is easy to heat, it a proper warehouse building. These are not proper warehouse buildings, they are of special purpose and they are valuable to anyone who can use them for that purpose or a similar purpose. Does that answer the question?

Mr. Ogden: Yes, I think that answers the question. Does that answer the Court's question?

The Court: It satisfies the Court. [38]

Mr. Ogden: That is all.

The Court: You are excused.

(Witness excused.)

The Court: We will take a short recess.

(Short recess taken.)

The Court: On the record.

Mr. Ogden: Mr. Melendy.

D. L. MELENDY

was called as a witness by and on behalf of the petitioner, and, having been first duly sworn, was examined and testified as follows:

The Clerk: State your name, Mr. Witness, and your address?

The Witness: D. L. Melendy, 323 North I Street, Tacoma.

Direct Examination

By Mr. Ogden:

Q. What is your business?

A. I am in the real estate business.

Q. How long have you been in the real estate business? A. Thirty-seven years.

Q. Have you had any experience in appraisal work? A. Yes.

Q. Give the Court some idea.

A. I have appraised for the State of Washington, Pierce County and the Federal Government. We just finished the appraisal [39] of the new county-city site in Tacoma, and that has been the principal part of my business in the last fifteen years, is appraisal work.

Q. Are you familiar with Lots 8 to 12, inclusive, of Block 2102 in the New Tacoma Fifth Addition?

A. Yes.

Q. Have you any idea of what those five lots were worth in 1946?

A. In the absence of comparable sales made in that area before 1946, that would be a yardstick for

(Testimony of D. L. Melendy.)

measuring the value, I went to the assessor's office to ascertain what the assessed value was. I find that about the turn of the century those lots had speculative value and they were appraised for taxation purposes according to the assessor's records at about $2800, those five lots back perhaps forty years ago—or forty years before '46, that was about the time the Milwaukee Railroad came into Tacoma when they had some speculative value and a great many people bought lots there. But since that time there has been no activity in the sales of those lots. Taking the record of the county I would say that those lots are worth, in 1946 were worth approximately $4,000, the five lots.

Q. Granted that the value of the five vacant lots was $4,000, is there any formula or any method by which you could determine what a fair ground rental of these vacant lots would be? [40]

Mr. Welch: Now, I want to make an objection at this time, your Honor, that the method or formula for evaluating vacant property in Tacoma in 1946 is irrelevant to this proceeding. I might indicate to the Court so far as the value is concerned, these lots were actually purchased by Mrs. Cunningham and it has been so stipulated, in 1944 within, oh, I would say fifteen months of 1946, and the price is set forth therein that she paid. So far as the formula for valuing vacant land, I don't think it belongs in this proceeding. I don't think it is necessary for a decision in the case because really

(Testimony of D. L. Melendy.)

that isn't the issue. The issue is with respect to the improvements.

The Court: I understand your position, but if that is a part of the taxpayer's contention I am disposed to let in and decide what relevancy it may have later. It may not be relevant according to which of these indeed is correct, but I will allow it to go in for whatever it may be worth in the decision of the case. The objection is overruled.

Q. (By Mr. Ogden): How would you go about it to determine the ground value?

A. I might explain to the Court this, that the average individual who purchases such lots purchases them with the idea that some day they will be more valuable and I have a great many instances of property I have handled where we have [41] permitted signboard companies to use the lots for paying the taxes. Sometimes it didn't pay the taxes, but I would say that a fair rental value for those lots, based upon $4,000 valuation, would be five per cent of the $4,000 plus the taxes. Most any property owner would be glad to get an income on vacant lots because they are usually a liability.

The Court: May I interrupt to ask a question?

Mr. Ogden: Yes, sir.

The Court: If the $4,000 should not be the proper valuation and the proper valuation some other figure evidenced by the purchase price paid by Mrs. Cunningham, would you say that the fair return would be five per cent of that other figure?

The Witness: Yes, I would.

(Testimony of D. L. Melendy.)

The Court: Plus taxes?

The Witness: I would say that it would be more than fair to the property owner because of the fact that when he buys vacant lots he does not expect to get any income out of them until they are improved or until the value has been enhanced and he can realize a profit.

The Court: Now, I would like to ask one other question. I suppose the location of the lots may have something to do with that, does it not?

The Witness: That is true.

The Court: Do I understand that these lots in 1946 [42] were in fairly close proximity to manufacturing plants?

The Witness: Yes, it is sort of in between. "A" Street at this point has a dead end two blocks north and as you go south about six blocks it goes into a gulch that is another dead end. It had practically no value from signboard—most vacant lots are used for signboard rentals in a district where it is that close into a city, but there was practically no traffic on "A" Street there because of the dead end street. To the north it ends, the dead end ends about Nineteenth Street, then starts again at Fifteenth Street. The union depot takes the street from about Nineteenth Street north.

The Court: You have taken all of that into consideration and the proximity to manufacturing concerns in fixing your valuation?

The Witness: That is right.

(Testimony of D. L. Melendy.)

The Court: I have no further questions. I didn't mean to interrupt the orderly procedure here.

Mr. Ogden: I have no further questions.

Cross-Examination

By Mr. Welch:

Q. Mr. Melendy, do you know what Mrs. Cunningham paid for these lots in 1944?

A. I do not. I was not informed of that. I was asked to place a valuation on those lots approximately ten years ago and I don't know what the sale was to Mrs. Cunningham, or for [43] her.

Q. For your information I will read from stipulation of facts and the first sentence of paragraph 8 which is a fact-wise agreed upon for purposes of deciding this case, it says "On October 26, 1944, Grace H. Cunningham purchased Lots 7 to 12, that would be 6 lots, inclusive, of Block 2102 at a price of $8,000." Now, what I want to ask you is whether prices generally of this type of land increased or decreased as between 1944 and 1946?

A. Well, about the same time across the street a building that had a valuation of at least $40,000 was sold for around $30,000 and it occupied, I think, five lots. This was practically the only sale that has been made in that area for a good many years of vacant lots.

Mr. Ogden: May I say, counsel, I am not going to quarrel about the valuation, we have stipulated what she paid for it. Now, these men have stated their own judgment. It is stipulated what she paid

(Testimony of D. L. Melendy.)

for the lots in '44. Primarily what I want for the witness is how you fix ground rental, irrespective of the problem being stated in this wise, the value of a certain piece of unused empty property, vacant property is "X," how would you figure or ascertain the ground value of "X"? Now, I would just as soon it be that as any particular value. It is a question of how you arrive at the rental. Of course, the top price would be the price Mrs. Cunningham paid which [44] would be $1,333.00 a lot.

Mr. Welch: In view of Mr. Ogden's representations, I have no further questions of this witness.

The Court: That is all then, you are excused.

(Witness excused.)

Mr. Ogden: Call Mr. Greenstreet.

KELVIN GREENSTREET

was called as a witness by and on behalf of the petitioner, and, having been first duly sworn, was examined and testified as follows:

The Clerk: Will you state your name and address, please?

The Witness: Kelvin Greenstreet, 2445 West Lynn, Seattle.

The Clerk: What was your first name?

The Witness: K-e-l-v-i-n.

Mr. Welch: If your Honor please, I have here a typewritten statement, the qualification of the witness. Now, I don't know what the practice in this Court is to file that, give it to the Court and file it

(Testimony of Kelvin Greenstreet.)

or shall I read it into the record? These are his qualifications. I can read them into the record. Ordinarily our practice here on an expert witness is to qualify him and he generally has with him his qualifications. I can read them in the record or file them.

The Court: If counsel for the respondent agrees they [45] may be read in the record. Normally, however, you ask the witness his qualifications under oath.

Mr. Welch: I would prefer, your Honor, that the witness be interrogated with respect to his qualifications.

The Court: Very well.

Direct Examination

By Mr. Ogden:

Q. Will you state your qualifications as to your experience in the field of appraisals and valuations of real property?

A. Beginning in 1938 I entered the real estate business as a salesman with Curtiss Milbrook and under him studied appraisal work as well as doing property management. After two years I became an appraiser for the Federal Housing Administration, in 1943 I was given charge of the subdivisions of large-scale development of single-family homes, handling the appraisals of them as well as the design and layout. In 1945 I became assistant chief appraiser for FHA. In 1947 I was assigned to

(Testimony of Kelvin Greenstreet.)

handle the apartment house program called the 608 rental housing program, appraised some $40,000,000 worth of apartment houses throughout the western part of the state at that time. Then from 1950 to 1955 I was the chief property manager for Federal Housing Administration and managed a 544-unit apartment project, together with a 150-unit rental project in Tacoma. I might state that in Tacoma I handled the appraisal [46] which resulted in the construction of Park towers and several other apartment houses. As late as two months ago I appraised the new post office building in the City of Tacoma for the General Services Administration. That is generally my experience.

Q. What positions do you now hold in professional societies, appraisal societies, if any?

A. I am a member of the real estate board of Seattle and chairman of the appraisal committee of the real estate board, and a member of the Society of Residential Appraisers, a member of the Right-of-Way Association, president of the American Institute of Real Estate Appraisers.

Q. Mr. Greenstreet, I think just as you came into the courtroom I made a statement that it was the desire of the taxpayer to introduce evidence before this Court as to an accepted method, if any there be, to determine a fair ground rental on unoccupied real property. Have you had any experience or do you know of any method whereby fair ground rental can be determined from the valuation or the location of vacant real property?

(Testimony of Kelvin Greenstreet.)

A. Yes, the value of ground rental is a common problem in the center of large metropolitan cities and in the more hilly retail areas where land values are high, many people own property, just the land and not the building, the land is held and they expect a certain return and it will vary as to the [47] quality of the neighborhood and the possible use of the land. Now, as you broaden out and reach the periphery of the high retail centers fewer and fewer people hold land as a rental investment. However, there are cases where they do, and in the outlying areas as I understand your subject case is here usually you start with a hypothetical new building and determine what is fair rate of capitalization would be on that hypothetical new building, allow a reasonable amount for depreciation, and the remainder would be the rental value of the land.

Q. This land in question are lots 5 to 7 in Block 2102 of the Fifth Addition to the City of Tacoma and lots 8 to 12 in Block 2102. This property is about three blocks from the depot, it is bounded on the south by Twenty-second Street, and on the east by "A" Street, and on the west by a 40-foot alley. The question is in 1946, January 1, what would be the fair rental value of this property? Now, there has been a stipulation of fact filed in this case in which counsel for both the Government and the taxpayer have agreed. In that stipulation of fact this property, with these lots at that time six of them were purchased for $8,000. One of those lots has been sold. That leaves five lots and the lot that was

(Testimony of Kelvin Greenstreet.)

sold was sold for a consideration of one-sixth of $8,000, so that leaves the five lots remaining and the value per lot would be $8,000 divided by six, which would be $1,333.33. That would [48] make these five lots valued at roughly around $6,000. What would this vacant property, what would be a fair ground rental on this vacant property with a valuation of roughly $6,666 in 1946, in your opinion, and how would you arrive at it?

A. Assuming that a commercial type of building would be erected upon the property as I understand it, the zoning in that particular area is commercial, light manufacturing, and assuming a light manufacturing commercial building would be erected upon the property, normally a nine per cent capitalization rate would apply, and that type of improvement is generally given a two and a half per cent depreciation which leaves you a return to the land of six and a half per cent. Therefore, six and a half per cent would be the return based upon your statement that the land is worth $6,000, then, six and a half per cent would be, of that, would be the return per year, approximately $380.00.

Q. Would that be plus or minus the taxes?

A. That would be a net return, taxes having been paid by the party who owned the building.

Q. The lessee would pay the taxes under that situation? A. Yes.

Mr. Ogden: That is all.

The Court: Can you figure precisely what that figure would be according to that calculation?

(Testimony of Kelvin Greenstreet.)

The Witness: Six times six and a half, $380.00 per [49] year.

Mr. Ogden: How much?

The Witness: $390.00 per year.

Mr. Ogden: You may examine unless the Court has some questions.

Cross-Examination

By Mr. Welch:

Q. Mr. Greenstreet, that $390.00 a year is based upon an assumed valuation of $6,000?

A. Yes.

Q. You are not familiar with this particular piece of property, that is, you don't have this property individually in your mind, do you?

A. I have a general idea. I am generally familiar with the area, but I have not made a specific inspection of the property.

Mr. Welch: I have no further questions at this time, your Honor.

Mr. Ogden: I have no further questions.

The Court: Very well. Thank you, sir, you are excused.

(Witness excused.)

Mr. Ogden: Mrs. Cunningham, will you take the stand?

Q. When was the American Manufacturing Company itself incorporated? A. 1936.

Q. State to the Court what is your position with the American Manufacturing Company?

A. I am general manager and the financial head of it.

Q. Was this your position in 1946?

A. Yes. It has always been my position. [51]

Q. In 1945, coming now towards the end of the year of 1945, state to the Court whether or not the American Manufacturing Company was seeking to expand its business or——

GRACE H. CUNNINGHAM

was called as a witness by and on behalf of the petitioner, and, [50] having been first duly sworn, was examined and testified as follows:

The Clerk: State your name and address?

The Witness: Grace H. Cunningham, 2026 Louisa Street, Seattle.

Direct Examination

By Mr. Ogden:

Q. Where is your place of business, if any?

A. 2119 Pacific Avenue, Tacoma.

Q. With what company or corporation are you connected with?

A. American Manufacturing Company, Incorporated.

Q. When did you first engage in the character of business now operated by the American Manufacturing Company? A. In 1928.

Q. When? A. In 1928.

(Testimony of Grace H. Cunningham.)

A. (Interrupting): The American Manufacturing Company either had to expand their business in that location or had to move to another location. They did not have space enough in which to operate.

Q. Was there at that time any land available for use for the expanding business of American Manufacturing Company?

A. Yes, directly in back of the present plant on Pacific Avenue there were five lots facing "A" Street directly across an unimproved alley.

Q. State whether or not the American Manufacturing Company since, and its predecessor in interest since 1928 had been making any use of those vacant lots?

A. They have used them ever since 1928.

Q. During the period of time from 1928 to 1944, did the American Manufacturing Company pay anything to the owners of record, owners of the property, for their use of the lots?

A. They paid approximately $110.00 for the use of them which was $10.00 per month from 1944 to approximately February, 1945.

Q. Is that all of the money that was ever paid?

A. That is all of the money that we ever paid; prior to that we had always used them for [52] nothing.

Q. How did it come about that you paid $110.00 for that period of time?

A. Well, we erected a craneway and the owners of the property thought that we possibly should pay something for them and give them an agreement to

(Testimony of Grace H. Cunningham.)

remove the craneway. We did not own the property when we built the craneway.

Q. I hand you now a photograph, and ask you to state, if you will, what that photograph shows?

A. This is the craneway that we erected to lot No. 9, which is 25 feet by 120 feet long.

Q. Does that show the craneway?

A. Yes, it does.

Mr. Ogden: I should like to introduce that in evidence if I might and have it marked Petitioner's Exhibit No. 5.

Mr. Welch: Could I inquire as to this?

Mr. Ogden: Yes.

Mr. Welch: Tell the Court, please, if you recall, approximately when this picture was taken?

The Witness: It was taken approximately 1944, I believe. We erected the craneway in 1944.

Mr. Welch: And this is the craneway in the almost-completed condition?

The Witness: Yes, this is the craneway on Lot No. 9.

The Court: I think you are looking at different pictures, aren't you? [53]

The Witness: It should be the same picture.

The Court: Is that the same picture?

The Witness: Yes.

Mr. Welch: I have no objection, your Honor.

The Court: It will be received.

(Petitioner's Exhibit Number 5 was marked for identification and received in evidence.)

PETITIONER'S EXHIBIT NO. 5

(Testimony of Grace H. Cunningham.)

Q. (By Mr. Ogden): Looking now at the photograph, state to the Court what else was done with this craneway other than as depicted by this picture?

A. In 1945 we closed in the outside by putting large steel and glass windows about 17 by 18 feet.

Q. Was that for the full 120 feet?

A. Full 120 feet, correct.

Q. When, if at all, did you buy these lots?

A. In 1944.

Q. In——

A. (Interrupting): Approximately October, 1944.

Q. October, 1944? A. Correct.

Q. Will you state to the Court why you bought these lots?

A. I bought them so that my company, the American Manufacturing Company, had working space. They couldn't afford to [54] buy them themselves.

Q. At this time——

Mr. Welch (Interrupting): ——I want to make a motion to strike the last part of the answer.

The Court: It will be stricken as not responsive.

Q. (By Mr. Ogden): At this time in 1945, the latter part thereof, was there any negotiations entered into between the American Manufacturing Company and yourself respecting these lots in question, the five lots?

A. They were to use the five lots for nothing, provided they paid the taxes, any improvements

(Testimony of Grace H. Cunningham.)

that they put on them were not to be of any cost to me. They had been using them since 1928 and they wanted to continue on using them.

Q. Was there at the time of this arrangement, namely, the agreement you refer to of the last part of 1945, was there an oral agreement covering what they might do with these lots? A. Yes.

Q. Now, state to the Court what that oral agreement was?

A. The oral agreement was that they were to, that they could erect an addition to the present craneway.

Q. That would cover what lot?

A. Lot No. 8.

Q. And what was on the other side of Lot No. 8?

A. The Graybar Building. [55]

Q. Lot No. 8 was 25 feet in width the same as 9?

A. Correct, by 120 feet long.

Q. State to the Court whether or not there was any intent on the part of yourself as owner of these five lots and the American Manufacturing Company relative to rent? A. There was——

Mr. Welch (Interrupting): May I object at this time, your Honor? Petitioner's counsel is asking petitioner to state a conclusion which is a matter for the Court to decide, this question of intent with respect to rent is very, very close to the case itself, and the issue of the case.

The Court: I understand it, Mr. Welch. May I ask the witness a question or two?

I believe you said, Mrs. Cunningham, that you

(Testimony of Grace H. Cunningham.)

started out with an oral agreement here and later there was a written agreement?

Mr. Ogden: That is right, a year and two months later.

The Court: Now, you say there was an agreement between yourself as owner of the lots and the company? What is the name of the company?

Mr. Ogden: American Manufacturing Company.

The Court: American Manufacturing Company. Now, with whom did you have such an agreement? As I understand it you were the owner of the [56] company?

The Witness: I control the stock.

The Court: Were you dealing with yourself or were there others who entered into this agreement?

The Witness: I was dealing with my brother, Thomas Gepford.

The Court: And yourself on the other hand?

The Witness: Yes.

The Court: And yourself singly on the other?

The Witness: That is right.

Mr. Ogden: I might suggest that when you look at the minutes of the meeting it recites that she was not in the room at the time the matter of the authorization on behalf of the corporation to rent these—to take these properties over and build the building, because where interested she withdrew from the meeting.

The Court: That applies to the oral agreement?

Mr. Ogden: Yes.

The Court: Now I understand your objection, Mr. Welch. You had the same objection awhile ago.

(Testimony of Grace H. Cunningham.)

Mr. Welch: Yes.

The Court: I was inclined at that time to agree with you that we were coming pretty close to having the witness testify as to a legal conclusion that this Court is going to have to reach itself. However, I am going to receive her answer on this for whatever it may be worth, but I am going to [57] warn you that the Court is going to take into consideration all the evidence.

Mr. Ogden: I certainly agree with that and it is being introduced on the basis of proving intent and that right to prove intent is based on many, many cases involving identical situations of determining what was the agreement relative to structures placed by a lessee upon his property.

The Court: The objection is overruled. The witness may answer.

A. I had no intent of rent. I was only concerned with acquiring additional space for my company so that they could exist in that location.

Q. (By Mr. Ogden): Do you know whether or not the American Manufacturing Company, after January 1, 1946, did place any improvements on this property?

A. They placed a 25 by 120-foot structure, a roof, a floor, and two ends which adjoined the Graybar Building.

Q. The stipulation entered into and now on file states that the cost of this improvement to which you have just testified was $11,094?

A. Correct.

Q. Does $11,094 represent the amount paid by

(Testimony of Grace H. Cunningham.)

the American Manufacturing Company for these improvements? A. That is right. [58]

Mr. Ogden: I am going to ask this exactly in the wording of the Commissioner in his letter.

Q. (By Mr. Ogden): Were these the improvements that were to revert to you under the terms of the lease on the first day of January, 1952?

A. Yes, correct.

Q. Referring now to your connection with the company as its manager, how much time do you put in? A. Six days a week.

Q. Six days a week? A. Correct.

Q. On January 1, 1946, how much money did the American Manufacturing Company at that date owe to banks?

A. They owed about $100,000 to the bank plus about $125,000 to Cunningham Steel Foundry.

Q. That is as of the date that you purchased the property in October, '44?

A. Approximately $41,000 to Puget Sound National Bank at Tacoma.

Q. Now coming to January 1, 1946, what was the approximate amount they owed the banks?

A. They owed the bank about $172,000.

Q. Were you personal endorser and guarantor on there? A. I was and still am. [59]

Q. What did they owe at the end of 1946?

A. About $184,000.

Q. Were you also the endorser and guarantor on that? A. Yes.

Q. In the year 1952, being six years after the

(Testimony of Grace H. Cunningham.)

agreement was entered into on January 1, 1946, what, if anything did you then do with regard to these lots on which these improvements had been placed?

A. I entered into another agreement with the American Manufacturing Company at $10.00 per month for a period of ten years.

Mr. Ogden: A copy, if your Honor please, of that lease is attached to the stipulation.

Q. (By Mr. Ogden): During the six-year period following January 1, 1946, was there any change in the buildings made by the American Manufacturing Company, drawing your attention to the south wall?

A. In September, 1951, we removed the south wall and moved it on over into another section that we were constructing at that time. We took out the entire south wall, moved it onto Lot No. 10.

Q. Were the improvements placed upon these properties after January 1, 1946, of a permanent nature?

A. I would say not, due to the fact that they were [60] specially constructed for one particular purpose, that was for the manufacture of the type of machinery that we were making, and I wouldn't call them of permanent nature. In fact, if I was not connected with American Manufacturing Company I wouldn't want them on the property.

Q. Can you give the Court any idea of what the working life, normal life in terms of years, of the

(Testimony of Grace H. Cunningham.)

improvements put on the property by the Manufacturing Company during the time mentioned would be?

Mr. Welch: I don't think this witness is qualified as an expert to give an opinion of that nature.

Mr. Ogden: Well, I don't know, if your Honor please, she is the manager of the company that built it and she is the manager of the company that owns the surrounding property, adjoining property. If she doesn't know by actual experience, there are two schools, one of education and one of practice. She might not have a record of being an appraiser or being in real estate, but as a practical matter she probably knows more about it than anyone else.

The Court: What are you asking her?

Mr. Ogden: Her estimation in number of years of these properties that were—this improvement that was put on there.

The Court: Are you speaking about the physical life or the obsolescence or useful life, or what? [61]

Mr. Ogden: We will include them all, useful life or obsolescence or whatever in their opinion they would be, will they be obsolete. They have already testified that one whole side was torn away and taken somewhere else.

The Court: It sounds rather nebulous. Why don't you ask her each one of the things and I will accept her estimate of these things.

Q. (By Mr. Ogden): Do you think that these improvements that were placed upon the property

(Testimony of Grace H. Cunningham.)

by the American Manufacturing Company subsequent to January 1, 1946, have a useful life in excess of twenty years?

A. I don't believe so. I believe that by the time American Manufacturing's present lease, which expires in 1962, I believe that as far as they are concerned the buildings will be obsolete and will have be torn down and a new type of building put up.

The Court: You say obsolete. Why would they be obsolete, you mean just so far as that company is concerned?

The Witness: That is correct, yes.

Q. (By Mr. Ogden): Is the nature of the improvements such that it would be characterized as a special construction or a general improvement?

A. It is a special construction, the buildings are constructed [62] very high.

Q. For a special use?

A. Yes, for our special type of manufacture. They wouldn't have much value to anyone else unless they were doing similar manufacture and there is nobody else in the City doing similar manufacture to ours. In fact, I think I would have great difficulty in doing anything with them.

The Court: And yet, Mrs. Cunningham, in the lease I believe it is stipulated that those will remain on the property as your property at the end of the lease?

The Witness: That is right, but I believe if I was not connected with American Manufacturing, or if I was servering any connection with Amer-

(Testimony of Grace H. Cunningham.)

ican Manufacturing, I would have them give me an agreement to remove the improvements.

The Court: The oral agreement, is there any summary in the stipulation as to what the oral agreement was?

Mr. Welch: Yes, your Honor, in paragraph 11, the stipulation of facts, we stipulated that the minutes of the meeting substantially set forth the terms of the oral lease which was later reduced to writing in a written lease dated March 17, 1947. They are referring to Exhibit 2-B.

The Court: In other words, the terms of the oral lease were similar in its terms to the written lease?

Mr. Welch: That is right, and the oral lease is substantially set forth in the minutes which is Exhibit 2-B. [63]

Mr. Ogden: The stipulation is that it substantially sets forth the oral agreement. That is the reason, if your Honor please, that inasmuch as there was an oral agreement and by the time that they have got around to finally drawing this lease in March, 1947, the improvements had long since been in and it was an occupancy and that is the reason I am directing attention to this oral agreement because it was under that that they operated because they certainly didn't operate under any written agreement, because it wasn't in existence.

Q. (By Mr. Ogden): State to the Court whether or not in your opinion, as the owner of these lots, the improvements put upon the property

(Testimony of Grace H. Cunningham.)

by the American Manufacturing Company after after January 1, 1946, lent any value or additional value to the property other than vacant property so far as you are concerned as an owner?

Mr. Welch: I object, your Honor, that again calls for an opinion and it also involves a conclusion more or less as it relates to this case. She is asked to state whether the improvements which admittedly cost something in excess of $11,000, in her opinion added anything to the value of the vacant land, and I think that calls again for expert testimony. It can't be answered by this witness.

The Court: I am inclined to agree with counsel except that I think the owner of the property and the petitioner here has a right to express her opinion. [64]

Mr. Ogden: Yes.

The Court: Now, for whatever it may be worth, I will receive her answer on that. It goes to the weight of the evidence.

A. As the property owner, I would say they had no value. I wouldn't want them on there if I was just the property owner. I would want the buildings off.

Q. (By Mr. Ogden): How was the account relative to the money expended by the American Manufacturing Company on the lots in question carried on the books of the American Manufacturing Company, if you know?

The Court: I understood that that was stipulated, is that correct?

(Testimony of Grace H. Cunningham.)

Mr. Ogden: I think that is stipulated. I withdraw that question, it is in the stipulation.

Q. (By Mr. Ogden): Coming now to the party wall agreement, Mrs. Cunningham, when was that entered into, if you know?

A. The party wall agreement?

Q. Yes.

A. I believe 1946. I am not real definite on the date, but I believe it was 1946.

Q. The party wall agreement, did that have anything to do with the oral agreement of the lease, was it a part of your [65] oral agreement of the lease, the party wall? A. Yes.

Q. In what respect?

A. I don't know exactly what you mean, Mr. Ogden.

Q. Well, I will ask the question in another way. The party wall agreement recites that yourself and the American Manufacturing Company are the joint owners? A. Correct.

Q. Of one-half interest in that party wall?

A. That is right.

Q. Is that right? A. Yes.

Q. The price of that party wall has been set forth in the stipulation. Has there been any change from that date to this in the ownership of that party wall with respect to yourself and the American Manufacturing Company?

A. None whatever.

Mr. Ogden: I think that is all.

(Testimony of Grace H. Cunningham.)

Cross-Examination

By Mr. Welch:

Q. Mrs. Cunningham, you were present, were you not, at the directors' meeting of December 15, 1945, when the oral lease was entered into?

A. Yes.

Q. And you are familiar, are you not, with the contents [66] of the minutes that are part of the stipulation? A. Yes.

Q. And you knew at the time that the American Manufacturing Company undertook the improvements that these improvements would become yours at the end of the six-year period?

A. Correct.

Q. And you are aware that that was later entered into in a written lease agreement?

A. That is right, yes.

Q. Now, American Manufacturing Company insures these buildings, does it not?

A. Correct, yes.

Q. Will you state, if you know, whether or not you personally are insured against any possible loss, fire or any other casualty as to these improvements?

A. Do you mean do I carry personal insurance?

Q. Or does the policy which the company carries also protect you? A. No.

Q. Could you state, if you know, approximately when the additions were made to the party wall between the American Manufacturing Company and the Graybar Building?

(Testimony of Grace H. Cunningham.)

A. They were made approximately in November, 1945.

Q. That is, the party wall itself?

A. Yes, that is the first section that was put up. [67]

Q. When was the addition to the party wall?

A. You mean the improvement to the 25-foot section that was already up between that section and the Graybar wall?

Q. Yes.

A. That went up at about the same time that the Graybar wall went up. It had to go up in one unit pretty much.

Q. Is the American Manufacturing Company's building, is that much higher than the Graybar Building?

A. It is approximately eight to ten feet higher than the Graybar Building.

Q. You stated that a certain portion of the American Manufacturing Company's building was moved to Lot 10 of this same block?

A. The south wall.

Q. That is the south wall?

A. The south wall was removed from Lot 9 and put on Lot 10.

Q. Which you also own?

A. I own all of the lots.

Q. And approximately when was that wall, the south wall, moved?

A. It was September, 1951.

(Testimony of Grace H. Cunningham.)

Q. Do you know approximately the cost of that subsequent improvement?

A. Of the south wall that we moved? [68]

Q. Yes. A. It was approximately $2,550.

Q. The American Manufacturing Company is required to keep and maintain the building and these improvements in good condition, is it not?

A. That is correct.

Q. What would you say their condition was at the present time?

A. Well, it is about the same condition that you would find in any wooden structure building, the roof has to be renewed about every three years, it has a car decking roof with laminated paper, tar and paper roof, that is renewed about every three years. We have to keep the roof in good condition or we wouldn't keep workmen. But it deteriorates in about another three to five years.

Mr. Welch: I have no further questions.

Mr. Ogden: If your Honor please, I have no further questions, but there is one matter now I want to take up with the Court and to this my friend across the table is going to object because he has already told me so.

The Court: You are excused, Mrs. Cunningham.

(Witness excused.)

Mr. Ogden: I do now want to introduce in evidence the original—a copy of the original report of the agent.

The Court: For what purpose? [69]

Mr. Ogden: For the purpose he sets forth in his report the reason for levying the additional assessment. He also sets forth his computation of how he arrives at the figure. That same computation and that same figure is carried clear through. This is the base of the whole procedure. And I should like very much to have it introduced in evidence.

The Court: What objection does the respondent have to allowing it in for that purpose?

Mr. Welch: If your Honor please, of course the 90-day deficiency letter states for itself in this respect, the revenue agent's report is not really a binding document on the Commissioner, it is merely the revenue agent's own view as to the controversy and sets forth a proposed deficiency based upon his opinion as to the nature of the controversy, and, of course, that is all more or less measured when the deficiency letter is issued, and I think the deficiency letter should cover the Government's position in this proceeding. We shouldn't have to necessarily consider ourselves bound by the contents, particularly the legal statements that are contained therein.

The Court: The Commissioner's determination is contained in the deficiency letter, is that your position, anything prior to that is preliminary and doesn't represent the Commissioner's final action. Is there any particular reason why you need to know what some of the preliminary conclusions or opinions were of the agent, Mr. Ogden? [70]

Mr. Ogden: The agent sets forth the reasons why he levies this assessment and he sets forth a

ruling of the Department upon which he bases his authority to make this assessment. From that position the Commissioner has seen fit to move away. Then the Commissioner comes along and he gets a 90-day letter in which he carries exactly the same figures and comes to exactly the same conclusion of $6,730.84, alleging that that was the gross income subject to tax because the building at that year of '46 was—the improvements were erected in '46, then he comes along a little later and changes his mind again and levies another assessment which is some $2,000, pretty near $3,000 more than the year 1952.

Now, it seems to me that I have a right to—I know this isn't binding on the Commissioner, I know that, but I do think that I have a right to show what was—how did it all start and why did it start and here is why it started. The Commissioner comes along and while he doesn't——

The Court (Interrupting): I don't think we are concerned with why, we are concerned with what the Commissioner did, his deficiency notice and whether he is correct as to '46 or '52. That is the question before the Court.

Mr. Ogden: Yes, or at all.

The Court: That is right. Now, the revenue agent's report cannot be accepted to prove any facts.

Mr. Ogden: That I agree to. [71]

The Court: I don't see how we are concerned with what went on before that, before the issuance of the notice of deficiency, it is inter-office work-

ings. I am frank to say that if that is put in, I don't think it will have any effect at all on the case. I would be inclined to let it in unless the Commissioner objects strenuously, telling you all the while that I don't know that it can be of any value in determining the case.

Mr. Ogden: I don't know, to be very frank, at this minute now I don't know whether the Commissioner bases his right to levy these assessments on the same grounds as the revenue agent or on what grounds he does it. I haven't yet been told.

The Court: Well, it doesn't make too much difference to the Court. I suppose it can be argued in the briefs and it will be up to the Court to determine what the grounds are, whether there are any proper grounds for taxing it in either one year or the other. Unless you insist I think I would prefer not to have the record encumbered with it.

Mr. Welch: Respondent rests.

The Court: How about briefs?

Mr. Ogden: I don't know how long it will take to get a brief ready. As far as I am concerned this matter was briefed once before when we had the hearings here. I could have a brief ready in ten days or two weeks or I can have it [72] ready in whatever anybody says.

The Court: The Court is in no great hurry. I have an abundance of work. You may have whatever reasonable amount of time you would like.

Mr. Welch: The respondent would like sixty days.

The Court: Do you want to file simultaneous briefs, sixty days?

Mr. Ogden: I do not know if that is the custom in the department. It is quite all right providing it is understood that I would have an opportunity to reply.

The Court: Thirty days thereafter you will have an opportunity to reply to each other's briefs.

The Clerk: Those dates are July 16 and August 16, counsel.

The Court: Very well, the case will stand submitted when the briefs are submitted.

We will take a five-minute recess.

Mr. Ogden: I am through with this case.

The Court: Is everything concluded?

Mr. Welch: Respondent rests.

The Court: Well, the case will stand submitted. We will take a short recess before going on with the next case.

(Whereupon, at 12:05 o'clock p.m., the hearing in the above-entitled petition was closed.)

Filed June 6, 1956, T.C.U.S. [73]

In the United States Court of Appeals
for the Ninth Circuit

T. C. Docket No. 55090

COMMISSIONER OF INTERNAL REVENUE,

Petitioner on Review,

vs.

GRACE H. CUNNINGHAM,

Respondent on Review.

PETITION FOR REVIEW

The Commissioner of Internal Revenue hereby petitions the United States Court of Appeals for the Ninth Circuit to review the decision entered by the Tax Court of the United States on June 25, 1957, ordering and deciding that there is no deficiency in income tax for the year 1946.

This petition for review is filed pursuant to the provisions of sections 7482 and 7483 of the Internal Revenue Code of 1954.

Taxpayer Grace H. Cunningham's individual income tax return for the year 1946, was filed with the Collector of Internal Revenue at Tacoma, Washington, which office is within the jurisdiction of the United States Court of Appeals for the Ninth Circuit.

Nature of Controversy

Taxpayer Grace H. Cunningham was a principal stockholder and general manager of the American Manufacturing Company, Inc. In December, 1945, she entered into an oral lease with the corporation under which she agreed to lease certain unimproved land to the corporation for a term of six years commencing January 2, 1946. The corporation was obliged to construct a building of the approximate value of $25,000 on the leased premises and to pay all taxes. The consideration for the lease was stated to be the transfer by the corporation of all its right, title and interest in the building at the end of the term of the lease.

Section 22(b)(11) of the Internal Revenue Code of 1939 provides that income, other than rent, derived by a lessor upon the termination of a lease and attributable to improvements made by a lessee shall be excluded from gross income.

The Commissioner contended that the transfer of the improvements at the end of the term of the lease was intended to be in lieu of rent so that the taxpayers realized taxable income in 1952 equal to the value of the improvements. In the alternative, the Commissioner contended that the erection of the improvements in 1946 was intended to be in lieu of rent so that the taxpayer Grace H. Cunningham realized taxable income in 1946 equal to the commuted value of her right to receive the improvements upon the termination of the lease. The Tax

Court held that the petitioner did not realize taxable income as a result of such improvements either at the time of construction thereof or upon termination of the lease.

/s/ CHARLES K. RICE, C.A.R.
Assistant Attorney General;

/s/ NELSON P. ROSE, C.A.R.
Chief Counsel,
Internal Revenue Service.

Filed September 16, 1957. T.C.U.S.

[Title of Court of Appeals and Cause.]

NOTICE OF FILING PETITION FOR REVIEW

To: Raymond D. Ogden, Esq.,
460-464 Olympic National Bank Building,
Seattle 4, Washington.

You are hereby notified that the Commissioner of Internal Revenue did, on the 16th day of September, 1957, file with the Clerk of The Tax Court of the United States, at Washington, D. C., a petition for review by the United States Court of Appeals for the Ninth Circuit of the decision of the Tax Court heretofore rendered in the above-entitled

cause. A copy of the petition for review as filed is hereto attached and served upon you.

Dated this 16th day of September, 1957.

/s/ NELSON P. ROSE, C.A.R.
Chief Counsel, Internal Revenue Service, Counsel for Petitioner on Review.

Service of Copy acknowledged.

Filed October 2, 1957, T.C.U.S.

[Title of Court of Appeals and Cause.]

Docket No. 55090

NOTICE OF FILING PETITION FOR REVIEW

To: Mrs. Grace H. Cunningham,
2026 Louisa Street,
Seattle, Washington.

You are hereby notified that the Commissioner of Internal Revenue did, on the 16th day of September, 1957, file with the Clerk of The Tax Court of the United States, at Washington, D. C., a petition for review by the United States Court of Appeals for the Ninth Circuit of the decision of the Tax Court heretofore rendered in the above-entitled cause. A copy of the petition for review as filed is hereto attached and served upon you.

Dated this 16th day of September, 1957.

/s/ NELSON P. ROSE, C.A.R.
Chief Counsel, Internal Revenue Service, Counsel for Petitioner on Review.

Service of Copy acknowledged.

Filed October 2, 1957, T.C.U.S.

[Title of Court of Appeals and Cause.]

T. C. Docket No. 55091

PETITION FOR REVIEW

The Commissioner of Internal Revenue hereby petitions the United States Court of Appeals for the Ninth Circuit to review the decision entered by the Tax Court of the United States on June 25, 1957, ordering and deciding that there is no deficiency in income tax for the year 1952.

This petition for review is filed pursuant to the provisions of sections 7482 and 7483 of the Internal Revenue Code of 1954.

Taxpayers' joint income tax return for the year 1952 was filed with the Collector of Internal Revenue at Tacoma, Washington, which office is within the jurisdiction of the United States Court of Appeals for the Ninth Circuit.

Nature of Controversy

Taxpayer, Grace H. Cunningham, was a principal stockholder and general manager of the American Manufacturing Company, Inc. In December, 1945, she entered into an oral lease with the corporation under which she agreed to lease certain unimproved land to the corporation for a term of six years commencing January 2, 1946. The corporation was obliged to construct a building of the approximate value of $25,000 on the leased premises and to pay all taxes. The consideration for the lease was stated to be the transfer by the corporation of all its right, title and interest in the building at the end of the term of the lease.

Section 22(b)(11) of the Internal Revenue Code of 1939 provides that income, other than rent, derived by a lessor upon the termination of a lease and attributable to improvements made by a lessee shall be excluded from gross income.

The Commissioner contended that the transfer of the improvements at the end of the term of the lease was intended to be in lieu of rent so that the taxpayers realized taxable income in 1952 equal to the value of the improvements. In the alternative, the Commissioner contended that the erection of the improvements in 1946 was intended to be in lieu of rent so that the taxpayer, Grace H. Cunningham, realized taxable income in 1946 equal to the commuted value of her right to receive the improvements upon the termination of the lease. The Tax Court held that the petitioner did not realize taxable

income as a result of such improvements either at the time of construction thereof or upon termination of the lease.

/s/ CHARLES K. RICE, C.A.R.
Assistant Attorney General;

/s/ NELSON P. ROSE, C.A.R.
Chief Counsel,
Internal Revenue Service.

Received and Filed September 16, 1957, T.C.U.S.

[Title of Court of Appeals and Cause.]

Docket No. 55091

NOTICE OF FILING PETITION FOR REVIEW

To: Raymond D. Ogden, Esquire,
460-464 Olympic National Bank Building,
Seattle 4, Washington.

You are hereby notified that the Commissioner of Internal Revenue did, on the 16th day of September, 1957, file with the Clerk of The Tax Court of the United States, at Washington, D. C., a petition for review by the United States Court of Appeals for the Ninth Circuit of the decision of the Tax Court heretofore rendered in the above-entitled cause. A copy of the petition for review as filed is hereto attached and served upon you.

Dated this 16th day of September, 1957.

/s/ NELSON P. ROSE, C.A.R.
Chief Counsel, Internal Revenue Service, Counsel for Petitioner on Review.

Service of copy acknowledged.

Received and filed October 2, 1957, T.C.U.S.

[Title of Court of Appeals and Cause.]

Docket No. 55091

NOTICE OF FILING PETITION FOR REVIEW

To: Grace H. Cunningham,
Eugene F. Cunningham,
2026 Louisa Street,
Seattle, Washington.

You are hereby notified that the Commissioner of Internal Revenue did, on the 16th day of September, 1957, file with the Clerk of The Tax Court of the United States, at Washington, D. C., a petition for review by the United States Court of Appeals for the Ninth Circuit of the decision of the Tax Court heretofore rendered in the above-entitled cause. A copy of the petition for review as filed is hereto attached and served upon you.

Dated this 16th day of September, 1957.

/s/ NELSON P. ROSE, C.A.R.
Chief Counsel, Internal Revenue Service, Counsel for Petitioner on Review.

Service of copy acknowledged.
Received and filed October 2, 1957, T.C.U.S.

[Title of Tax Court and Cause.]

Docket Nos. 55090, 55091

ORDER ENLARGING TIME

On motion of counsel for petitioner on review, it is

Ordered: That the time for filing the record on review and docketing the petitions for review in the United States Court of Appeals for the Ninth Circuit is extended to December 15, 1957.

/s/ J. E. MURDOCK,
Judge.

Dated: Washington, D. C., October 2, 1957.

Served October 3, 1957.

Entered October 3, 1957.

[Title of Tax Court and Cause.]

CERTIFICATE

I, Howard P. Locke, Clerk of the Tax Court of the United States, do hereby certify that the foregoing documents, 1 to 20, inclusive, constitute and are all of the original papers on file in my office as called for by the "Designation of Contents of Record on Review," including exhibits 1-A thru 4-D attached to the stipulation of facts and petitioners' exhibit 5, admitted in evidence, in the cases before the Tax Court of the United States docketed at the above numbers and in which the respondent in the Tax Court has filed petitions for review as above numbered and entitled, together with a true copy of the docket entries in said Tax Court cases, as the same appear in the official docket in my office.

In testimony whereof, I hereunto set my hand and affix the seal of the Tax Court of the United States, at Washington, in the District of Columbia, this 10th day of December, 1957.

[Seal] /s/ HOWARD P. LOCKE,
Clerk, Tax Court of the
United States.

[Endorsed]: No. 15815. United States Court of Appeals for the Ninth Circuit. Commissioner of Internal Revenue, Petitioner, vs. Grace H. Cunningham, Eugene F. Cunningham and Grace H. Cunningham, Respondents. Transcript of the Record. Petitions to Review a Decision of The Tax Court of the United States.

Filed December 12, 1957.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for the Ninth Circuit.

In the United States Court of Appeals
for the Ninth Circuit

No. 15815

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

GRACE H. CUNNINGHAM,

Respondent.

STATEMENT OF POINTS ON WHICH PETITIONER INTENDS TO RELY ON APPEAL AND DESIGNATION OF RECORD TO BE PRINTED

Pursuant to Rule 19(6) of the Rules of the Court of Appeals for the Ninth Circuit, the Commissioner of Internal Revenue, the petitioner herein, hereby designates the following statement of points upon which he intends to rely on appeal.

With respect to the appeal of T.C. Docket No. 55091, the Commissioner contends:

1. The Tax Court erred as a matter of law in failing to hold that taxpayers, Eugene F. Cunningham and Grace H. Cunningham, realized taxable income in 1952 equal to the then fair market value of improvements constructed by the lessee in 1946 upon the property involved subject to a six-year lease and which reverted to taxpayers in 1952 at the termination of the lease.

2. The Tax Court's finding that the value of the improvements made by the lessee did not represent rent upon termination of the lease in 1952 is clearly erroneous.

3. The Tax Court erred in failing to find the amount of the gross income received in 1952 by taxpayers, Eugene F. Cunningham and Grace H. Cunningham, attributable to the improvements placed upon the property by the lessee.

The Commissioner alternatively contends, with respect to the appeal of T.C. Docket No. 55090, as follows:

1. The Tax Court erred as a matter of law in failing to hold that taxpayer, Grace H. Cunningham, realized taxable income in 1946, as lessor, equal to the January 2, 1946, fair market value of improvements constructed by the lessee upon taxpayer's property, which improvements, pursuant to the lease, were to and did revert to taxpayer at the end of the six-year term.

2. The Tax Court's finding that the value of the improvements made by the lessee did not represent rent at the time of construction in 1946 is clearly erroneous.

3. The Tax Court erred in failing to find the amount of the gross income received in 1946 by taxpayer, Grace H. Cunningham, attributable to the improvements placed upon the property by the lessee.

The Commissioner of Internal Revenue, as petitioner herein, hereby designates the entire records of T.C. Docket Nos. 55090 and 55091, including this statement of points and designation, to be included in the printed record on appeal.

/s/ CHARLES K. RICE,
Assistant Attorney General.

[Endorsed]: Filed February 14, 1958, U.S.C.A.